

**Alberta Energy And Utilities Board**

**ATCO Pipelines**

**2003 2004 General Rate Application**

**Application No. 1292783**

**Written Evidence of John McCormick**

**on Behalf of**

**The City of Calgary**

**May 30, 2003**

J. D. McCormick Financial Services, Inc.  
Suite 920  
910, 7 Avenue South West  
Calgary, Alberta T2P 3N8

1 **Q.1 Please state your name, business address and occupation.**

2 A My name is John D. McCormick, and my business address is Suite 920, 910  
3 7<sup>th</sup> Avenue South West, Calgary, Alberta. I am a financial consultant and  
4 President of J. D. McCormick Financial Services, Inc. A description of my  
5 professional qualifications is found in Attachment 1.

6 **Q.2 What is the purpose of your evidence at this proceeding?**

7 A The City of Calgary has requested that I provide my views with respect to rate of  
8 return and capital structure that ATCO Pipelines seeks in this application.

9 **Q.3 Was the evidence prepared by you or under your direct supervision and**  
10 **control?**

11 A Yes.

12 **Q.4 How is your evidence organized?**

13 A I have divided my evidence into two parts. In the first part, I offer observations  
14 on ATCO Pipelines' applied for equity return and capital structure as compared to  
15 financial market requirements, and the financial performance of utilities which  
16 have equity returns set by an adjustment formula. In the second part, I reply to  
17 several statements in the materials filed in this application with respect to the  
18 proposed capital structure, methodology and changes in the financial markets.

19 **Q.5 Is the evidence in filed in this proceeding similar to that filed in the ATCO**  
20 **Gas and ATCO Electric proceedings?**

21 A Yes, this evidence is similar, but because of the many changes in the nature of the  
22 application it incorporates a great many changes from that filed in the previous  
23 applications. In both of the ATCO Gas and ATCO Electric applications, the  
24 requested rate of return was supported by internally prepared capital markets  
25 evidence which focused on a table suggesting increasing bond spreads from a  
26 point in the 1990's to a proximate date. In my evidence in those earlier  
27 applications, I commented on the bond data presented by the applicant. The  
28 ATCO Pipelines' application is supported by externally prepared evidence, which

1 in addition to addressing other matters, also makes certain similar observations  
2 with respect to Canada-utility bond spreads<sup>1</sup> and, as such, I repeat aspects of my  
3 earlier evidence. In addition to the many changes required by differences  
4 between this application and its predecessors, I have incorporated some additional  
5 material to clarify certain areas and material that arose as a result of oral and  
6 written questions in the earlier ATCO applications. Portions of this Evidence  
7 were originally developed for the AltaLink 2002/2003 – 2003/2004 GTA.

8 **Q.6 Please summarize your conclusions.**

9 A The combination of the 11.5% equity return applied for and the 50% common  
10 equity ratio<sup>2</sup> appear to be in excess of the current requirements of the financial  
11 markets, relative to the markets' perception of the underlying business risk of  
12 ATCO Pipelines.

13 A more appropriate equity return would be one derived from a formula similar to  
14 those used by the National Energy Board (“NEB”)<sup>3</sup> or the British Columbia  
15 Utilities Commission (“BCUC”)<sup>4</sup>, adjusted to recognize the shares of companies,  
16 which are the owners of most regulated utilities subject to those formulas, are  
17 trading at substantial premiums to the underlying book values. That adjustment  
18 should reduce the allowed return on equity to the 8.5% level recommended by  
19 Drs. Booth and Berkowitz.

20 The proposed capital structure places an unnecessary burden on the ratepayer as  
21 the equity layer increases beyond that which was approved by this Board (the  
22 “AEUB” of the “Board”) in Decision 2001-97 for ATCO Pipelines South, and the

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<sup>1</sup> See page 22 of 63, lines 2 to 8 and Schedule 8, Prepared Testimony of Kathleen C. McShane.

<sup>2</sup> See Section 1.1, page 1, lines 29-30.

<sup>3</sup> The RH-2-94 Decision, which established the NEB adjustment mechanism, covered Alberta Natural Gas Company Ltd, Foothills Pipe Lines Ltd., TransCanada Pipelines Ltd., Trans Mountain Pipe Line Company Ltd., Trans Quebec & Maritimes Pipeline Inc. and Westcoast Energy Inc. From time to time, certain of these pipelines have entered into negotiated settlements with their shippers and returns under those negotiated settlements may vary from that determined under the adjustment mechanism.

<sup>4</sup> The June 10, 1994 Decision of the British Columbia Utilities Commission on “Return on Common Equity” covered BC Gas Utility Ltd. (now Terasen Gas), Pacific Northern Gas Ltd. and West Kootenay Power Ltd. The return for Centra Gas Fort St. John was also determined to be the average of the ROEs allowed to BC Gas and PNG. See page 35.

1 levels at which the consolidated ATCO Pipelines has chosen to operate in recent  
2 years.<sup>5</sup>

3 **Part I**

4 **Q.7 What facts do you rely on to support this conclusion?**

5 A The best evidence of the appropriateness of the current equity return resulting  
6 from these adjustment mechanisms and the allowed capital structures is found in  
7 the trading prices of the shares of the companies which are the owners of the  
8 utilities that earn the returns allowed by these formula. The common shares of  
9 TransCanada, the public entity that investors must buy to participate in owning  
10 the Mainline and the BC System<sup>6</sup>, are trading at a material premium to book  
11 value.<sup>7</sup> The common shares of Terasen (formerly BC Gas Inc.), the public entity  
12 that investors must buy to participate in owning Terasen Gas,<sup>8</sup> Terasen Gas  
13 Vancouver Island (formerly Centra Gas British Columbia)<sup>9</sup> and the Trans  
14 Mountain Pipe Line<sup>10</sup>, are trading at a material premium to book value<sup>11</sup>.

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<sup>5</sup> In Decision 2001-97, the Board determined that a 45.5% equity layer was appropriate for ATCO Pipelines. See page 44 of the Decision.

<sup>6</sup> TransCanada's BC System is the former Alberta Natural Gas.

<sup>7</sup> On May 26, 2003, TransCanada shares were trading at 2.00 times the March 31, 2003 book value. Since December 1995, calculated on a quarterly basis, the shares of TransCanada have traded at an average 1.66 times book value. During that period the low was 1.02 times book, which occurred at March 2000, following an announcement of a dividend cut and multimillion after tax write down of certain unregulated assets. The high was 2.10 times book value.

While some authors may debate the appropriate small premium to allow an equity issue to be done without dilution, as the stock price approaches twice book value, it is hard to imagine markets so turbulent as to require a 100% floatation allowance. As the expected rate of return rises above the market's current requirements, the stock price rises, forcing the market to book ratio up. If the goal of the process is to provide a rate of return which is fair in the context of current and reasonably foreseeable capital market requirements, for a stand-alone utility, the market to book value is a very helpful, although not perfect, indicator.

<sup>8</sup> The BCUC formula governs BC Gas Utility (now Terasen Gas), but owing to the withdrawal of its 2002 application, the 2001 return on equity continued to apply in 2002. See the Terasen 2003 Annual Information Form page 7.

<sup>9</sup> Terasen Gas (Vancouver Island) (formerly Centra Gas British Columbia) has negotiated a 3 year incentive regulatory arrangement which expires in 2005. See page 9 of the Terasen 2003 Annual Information Form.

<sup>10</sup> Although Trans Mountain could be regulated under the NEB formula, it has a negotiated incentive toll settlement with its shippers. See the Terasen 2003 Annual Information Form page 12.

<sup>11</sup> On May 26, 2003, Terasen Inc. (formerly BC Gas) shares were trading at 1.71 times the December 2002 book value. Since September 2001, calculated on a quarterly basis, the shares of Terasen have traded at an average of 1.83 times book value.

1           Although the corporate structure of Canadian Utilities is less weighted to  
2           investments which enjoy the security of regulated returns than TransCanada, the  
3           prices of its securities also support this view<sup>12</sup>. The common shares of Canadian  
4           Utilities, the first public entity above ATCO Pipelines in the ownership chain that  
5           investors could buy to participate in owning ATCO Pipelines, are trading at a  
6           material premium to book value.<sup>13</sup>

7   **Q.8   Why should we care whether utility holding companies are trading above**  
8   **book?**

9   A    While regulatory boards have many responsibilities, one of them might be  
10   described as assuring the continued financial health of the utility. One of the tests  
11   to be met in the process of awarding the utility an appropriate rate of return is the  
12   capital attraction test<sup>14</sup>. Real world current market data shows that capital is being  
13   attracted to those companies as many utility holding companies in Canada are  
14   trading well above book, while earning a return on a large portion of those assets  
15   which is generally calculated with reference to the book value of the rate base.

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<sup>12</sup> The proportion of regulated assets was made a matter of record in each of the ATCO Gas and ATCO Electric proceedings. See CAL-ATCOGTA-125(a) in which ATCO Electric confirms the reply provided in CAL-AG-26(b) where ATCO Gas provides its calculation of the portion of assets that were subject to regulation for the period 1989 to 2001. For Canadian Utilities the portion of assets that were subject to regulation had fallen from a high of 97.23% in 1990 to 56.83% for 2001. For CU Inc. the portion of assets that were subject to regulation had fallen from a high of 99.99% in 1999 to 79.29% for 2001. In response to written questions by participants in the RH-4-2001 proceeding, TransCanada replied in ADOE 1.59 that the “unregulated business of TransCanada represents less than 10% of the total assets of the Company” and in CAPP 210, that the non-regulated businesses “do not have a material impact on TransCanada’s consolidated financial fundamentals.”

The directional importance of the change in the proportion of regulated investments can be inferred from the rating changes being applied to companies like TransAlta which have experienced a ratings reduction as the proportion of its regulated operations has declined. See also the DBRS Methodology in Rating Utilities, June 2002 in which the authors provide a general standard for Regulated, Mixed and Unregulated enterprises in which the debt capacity reduces from regulated to unregulated enterprises.

<sup>13</sup> As at May 26, 2003, Canadian Utilities shares were trading at approximately 1.8 times the March 30, 2003 book value. Since December 2000, calculated on a quarterly basis, the shares of Canadian Utilities have traded at an average of 1.96 times book value. CAPP-AP-67 provides some of the monthly closing prices and certain financial information for ATCO and Canadian Utilities.

<sup>14</sup> *In British Columbia Electric Railway Company Limited vs. Public Utilities Commission of British Columbia*, 1960 SCR 837.

1 **Q.9 Is it correct to use the prices of securities of the publicly held parent of a**  
2 **utility as a guide for determining whether the allowed return of the utility is**  
3 **adequate in light of the business risks that the utility faces?**

4 A While the analysis would be easier with publicly traded stand-alone utilities,  
5 important information can be drawn from the trading prices of the securities of  
6 utility owners. Since TransCanada, the public entity which owns several NEB  
7 regulated pipelines also owns other businesses, the view that we may obtain of the  
8 required returns from the prices of securities is a little blurred by the inclusion of  
9 those other businesses within the financing entity. Those other businesses have  
10 included both regulated and unregulated businesses. To the extent that the other  
11 regulated businesses have returns that move in parallel with the returns allowed  
12 by the NEB formula, there is little blurring.<sup>15</sup> To the extent that the proportion of  
13 unregulated business increases relative to the regulated businesses and the  
14 unregulated businesses have returns that vary from the returns allowed by the  
15 NEB formula, there may be more blurring. Fortunately, the relative size of the  
16 unregulated businesses within the financing entity has been reduced in recent  
17 years.<sup>16</sup> Share prices are the best evidence of the market reaction to TransCanada's  
18 expected relative returns. Even Mr. Lackenbauer, one of TransCanada's capital  
19 markets experts in the RH-4-2001 proceeding, testified that "the proxy for [the  
20 mainline], which is not a perfect proxy, is the TransCanada common equity".<sup>17</sup>  
21 While it would be ideal if the Mainline were in a separate financing vehicle so as  
22 to remove any blurring, it remains the largest asset and is therefore a major driver  
23 of TransCanada's results.

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<sup>15</sup> Certain of TransCanada's current pipeline investments were also part of the RH-2-94 decision, including Alberta Natural Gas Company Ltd, Foothills Pipe Lines Ltd., and Trans Quebec & Maritimes Pipeline Inc.

<sup>16</sup> On May 13, 2003, TransCanada announced that it had acquired the interests in the Foothills Pipelines companies owned by Duke Energy for consideration of \$257 million, including the assumption of \$152 million debt. Page 13 of the 2003 Annual Information Form of Westcoast Energy indicated an carrying value, as at December 2002, for those interests as approximately \$63.5 million, which indicates a market to book multiple of approximately 1.65 times. On December 23, 2002, TransCanada announced its participation in the purchase of certain nuclear generation assets in Ontario for a price of \$376 million.

<sup>17</sup> Mr. Lackenbauer was then Deputy Chairman of BMO Nesbitt Burns. See RH-4-2001 Hearing Transcript February 28, 2002 at line 2073.

1 The relative importance of the regulated returns to TransCanada's pipeline  
2 investments can be seen in the performance of those segments of the business to  
3 the profitability of the company as a whole. The table below compares the  
4 regulated returns on four of TransCanada's NEB regulated pipeline investments to  
5 the net income earned to common shareholders calculated on average common  
6 equity. The achieved returns data, in the middle four columns, was taken from  
7 NEB surveillance reports. From 1996 to 1999, the TransCanada Mainline  
8 enjoyed the benefit of an incentive arrangement and achieved returns above the  
9 formula. While in many years the percentage net income to common shareholders  
10 over average equity exceeded the return provided under the formula, it was not  
11 always the case. In 1998 and 1999, the unfortunate results of other portions of the  
12 enterprise caused the percentage net income to common shareholders to be less  
13 than those rates allowed under the formula, much less the incentive returns. It is  
14 noteworthy, that during the period 1996 to 2002, the average net income to  
15 common shareholders of TransCanada has not equaled the average of the allowed  
16 returns under the NEB formula for that period.

	Data from NEB surveillance reports					Net Income to Common to Average Equity
	Mainline Formula	Mainline Achieved	Foothills Achieved	TQM Achieved	ANG Achieved	
1996	11.25%	11.83%	11.25%	11.83%	11.25%	12.74%
1997	10.67%	11.15%	10.67%	10.94%	10.67%	12.21%
1998	10.21%	10.63%	10.21%	10.32%	10.21%	8.18%
1999	9.58%	9.64%	9.58%	9.94%	9.58%	-1.36%
2000	9.90%	9.99%	9.90%	9.96%	9.90%	13.97%
2001	9.61%	10.01%	9.61%	10.21%	6.68%	11.31%
2002	9.53%	9.95%	9.53%	9.80%	9.53%	13.37%
	10.11%	10.46%	10.11%	10.43%	9.69%	10.06%

17 The same concepts apply to other companies, like Terasen, where the major  
18 portion of its financial results are related to its regulated utility businesses. The  
19 relative importance of the regulated utility businesses will vary over time as each  
20 corporation acquires<sup>18</sup> and divests, but while the regulated utility businesses

<sup>18</sup> On November 19, 2002, BC Gas (now Terasen) announced the acquisition of an interest in the Express Pipeline.

1 remain a major portion of the business, their return on capital cannot help but be  
2 reflected in the trading price of the shares.

3 Similarly, Canadian Utilities Limited holds both regulated and unregulated  
4 investments and as such, consideration must be given to the changing risk profile.  
5 The prospective returns of the unregulated business, the relative proportion of  
6 regulated and unregulated businesses, and the capital structure of each firm will  
7 also be of interest to prospective investors.

8 It is also noteworthy, that the NEB and BCUC formulas generate slightly different  
9 returns<sup>19</sup>. For 2002, the NEB formula provided a 9.53% return to the utilities  
10 covered by its formula while the BCUC formula offered a 9.13% return to the low  
11 risk benchmark utility<sup>20</sup>. For 2003, the comparative rates are 9.79% and 9.42%.  
12 One of the factors giving rise to the difference is the cap on equity risk premium  
13 that exists in the BCUC formula when the forecast yield on the long-term Canada  
14 bond falls below 6%.

15 **Q.10 Surely, the use of the prices of the utility holding company shares as a proxy**  
16 **for the market required return on its regulated utility investment is a**  
17 **violation of the stand-alone principle and a misapplication of the capital**  
18 **attraction standard.**

19 A On the contrary, it is the use of the most obvious tool to arrive at a fair result.  
20 TransCanada argued this point in its review and variance application in respect of

<sup>19</sup> The table below shows the returns that have resulted from the application of each of the BCUC and NEB formulas since their inception, the difference between the returns in each year and the average difference over the period.

ROE in %	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	Average
NEB		12.25	11.25	10.67	10.21	9.58	9.90	9.61	9.53	9.79	
BCUC Benchmark	10.75	12.00	11.00	10.25	10.00	9.25	9.50	9.25	9.13	9.42	
		0.25	0.25	0.42	0.21	0.33	0.40	0.36	0.40	0.37	0.33

<sup>20</sup> BC Gas (now Terasen Gas) is the low risk benchmark utility, and the return on equity of other utilities covered by the formula will be slightly higher.

1 the RH-4-2001 Decision, but there is no other route for an investor to supply  
2 capital to the Mainline, in TransCanada's case, but through the public company.<sup>21</sup>

3 In many proceedings, competing proponents of the "comparable earnings"  
4 method and the "equity risk premium" method offer complex analysis of  
5 corporate earnings, discount cash flows and select varying time periods and  
6 geographical data sets<sup>22</sup> to estimate long term equity risk premiums and reach  
7 divergent conclusions as to the required utility rate of return. In these debates  
8 over the appropriate methods, I am reminded of the principle of "misdirection" in  
9 magic<sup>23</sup> as the focus on method seems to overshadow the outcome of the process.  
10 Those who would seek to misdirect regulators' attention may be hoping that those  
11 regulators will not place emphasis on the real world current market data, which  
12 shows many utility holding companies in Canada are trading well above book  
13 while earning a return on a large portion of those assets which is generally  
14 calculated with reference to the book value of the rate base.

15 We should little wonder at the fact that so many regulators have approved an  
16 adjustment formula when faced with differences between the company and  
17 intervenor experts. Having heard sometimes repetitive testimony supporting a  
18 range of recommended returns in each proceeding, and after making an award  
19 within the ranges recommended by regulatory experts, regulators can see the  
20 shares of the utilities trading at generous levels throughout the test period.

21 In this proceeding, we are being directed by the applicant to focus on a  
22 considerable amount of U.S. data and a table of bond spreads<sup>24</sup> rather than the  
23 market to book ratios of utility companies which are earning, in part, formula  
24 generated returns below that which the applicant seeks.

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<sup>21</sup> See page 19 of the Application for Review and Variance, dated September 16, 2002. Following the denial of the review and variance application in February 2003 by the NEB, TransCanada applied for leave to appeal the decision to the Federal Court of Appeal and was granted that leave May 26, 2003.

<sup>22</sup> The evidence filed in RH-4-2001 on behalf of TransCanada relied in large measure on U.S. data. TransCanada also proposed the use of the "ATWACC" method.

<sup>23</sup> Misdirection in magic is the practice of directing the attention of the audience away from the movement of the hand which is executing the trick and directing that attention toward some other object.

1 **Q.11 Surely, the use of the comparable earnings and the equity risk premium**  
2 **methods are enshrined in the legal precedents which establish the**  
3 **responsibilities of the regulatory boards?**

4 A While this is primarily a legal question, the *Hope Natural Gas* decision relates, in  
5 the language of its day that, “the return to the equity owner should be  
6 commensurate with the returns on investments in other enterprises having  
7 corresponding risks. That return should be sufficient to assure confidence in the  
8 financial integrity of the enterprise, so as to maintain its credit and to attract  
9 capital.”<sup>25</sup> It seems a very reasonable test, but like much of life, the devil is in the  
10 details. The difficult task is figuring out which companies have corresponding or  
11 similar risk, but we should not lose sight of the goal which is the adequate return,  
12 not the process of considering what earnings are comparable or the process of  
13 determining the optimal data to support the calculation of an equity risk premium.

14 Certain of the proponents of the “comparable earnings” method and the “equity  
15 risk premium” analysis strive to ignore the obvious. What is obvious to me is that  
16 the common shares of utilities are generally trading at prices giving rise to market  
17 to book multiples well above one. It is also obvious that major acquisitions of  
18 utilities are taking place by utilities and others at premiums to the trading market  
19 prices which were already at a premium to book value.<sup>26</sup> There is nothing quite  
20 like a takeover bid to demonstrate that capital is being attracted to the rate base of  
21 a utility.

22 While we are discussing an adequate return on equity as the goal of the “capital  
23 attraction” test, the November 2002, filing by TransCanada of a shelf prospectus  
24 for \$2 billion in Canada, and \$1 billion in the United States, covering common  
25 and preferred shares and debt, gives evidence to their need to attract capital in the

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<sup>24</sup> See Schedules 4, 5, 11, 16, 17, 20, 21, 22 and 23 to the Prepared Testimony of Kathleen C. McShane in the 2003-2004 General Rate Application.

<sup>25</sup> 320 U.S. page 591 at 603. This concept has been adopted in Canadian cases as well. At page 602, the decision also suggests that “it is the result reached not the method employed that is controlling.”

<sup>26</sup> Recent transactions include the Duke acquisition of Westcoast, the Enbridge acquisition of interests in Alliance, the BC Gas (now Terasen) acquisition of Express Pipeline, and the acquisition by TransCanada of the Duke interests in Foothills.

1 future. As equity tends to be more permanent capital<sup>27</sup>, utilities are more frequent  
2 issuers of debt. While some of this capital may go to ventures other than their  
3 NEB regulated assets, there is a constant need to refinance maturing debt. It is the  
4 equity return that helps underpin the debt obligations. In the absence of an equity  
5 return, the interest coverage would approach one. In that regard, one might have  
6 expected TransCanada and other companies regulated by the NEB formula to  
7 have been restricted in recent years in their capital market access by the allegedly  
8 low rates of equity return. For TransCanada, that appears not to have been the  
9 case.<sup>28</sup>

10 The senior debentures of TransCanada are and have been rated by DBRS as “A”  
11 since July 1998. The medium term note debentures of Terasen (formerly BC Gas  
12 Inc.) are rated by DBRS as “A (low)”. The long-term debt of Terasen Gas  
13 (formerly BC Gas Utility) is and has been rated by DBRS as “A” since at least  
14 1992. The senior debentures of Canadian Utilities are rated as “A” by DBRS and  
15 “A+” by S&P.<sup>29</sup> Debentures of each of these firms will trade at spreads over the  
16 comparable government bonds of similar term within the range that ebbs and  
17 flows as demand for credit changes over time.

18 **Q.12 Do you agree that ATCO Pipelines need be awarded an equity return of**  
19 **11.5%?**

20 A No, I do not. The ROE resulting from the NEB and BCUC adjustment  
21 mechanisms appear to be well within the range of what the market requires. In  
22 other words, they are generous. Assuming that its allowed capital structure is  
23 appropriate to its business, the 11.5% equity return ATCO Pipelines seeks is

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<sup>27</sup> While often viewed as permanent capital, many Canadian issuers have undertaken Normal Course Issuer Bids, which allow the repurchase of outstanding equity. Among those issuers which have repurchased shares in the past year, we would find Canadian banks, Caribbean Utilities and TransAlta Corporation. Canadian Utilities, on May 15, 2003, announced the renewal of its normal course issuer bid and reported on its purchases in the prior year.

<sup>28</sup> See RH-4-2001 proceeding transcript for February 27, 2001 at lines 820-1, where Mr. Girling of TransCanada replies to the question “When, since early 1999, have you been unable to raise debt on reasonable terms and conditions?” by saying “We haven’t been.”

<sup>29</sup> Certain ratings are found as attachments to CAL-AP-20, and ratings information on other utility issuers is found in CAL-AP-76 (f) and Schedule 1 to the Prepared Testimony of Kathleen C. McShane.

1 materially above the levels which the various adjustment mechanisms allow. The  
2 2002 NEB formula calculation produced an allowed ROE of 9.53% and, for 2003,  
3 a ROE of 9.79%<sup>30</sup>. The BCUC formula produced an allowed ROE of 9.13% for  
4 2002 and a ROE of 9.42% for 2003, in each case for a low risk benchmark  
5 utility<sup>31</sup>. Each of these formulas operate based on expected future bond rates. It is  
6 clear that they did not result in allowed ROEs of 11.5% for 2003. Based on the  
7 current interest rate conditions, with the 10-year Canada bond trading at yields of  
8 approximately 4.39%<sup>32</sup>, it is unlikely that these mechanisms will generate a rate  
9 approaching 11.5% for 2004<sup>33</sup>. A host of utilities are able to access the capital  
10 markets with the ROEs generated by these adjustment mechanisms. In my view,  
11 ATCO Pipelines has presented no realistic justification for its request for a return  
12 of 11.5%, which is about 170 basis points over what is allowed to companies  
13 regulated under the NEB adjustment mechanism.

14 **Q.13 Are there other utilities that have been awarded or negotiated an equity**  
15 **return of 11.5%?**

16 A Yes, there are examples of utilities being awarded or negotiating returns in the  
17 11% range but when discussing historical awards or negotiations it is important to  
18 remember the time or business context of that decision or agreement. While it is  
19 difficult to extract the equity return allowed in a “black box” or package  
20 negotiation, there are examples of negotiated returns in the 11% range. In  
21 Canada, the Alliance Pipeline is allowed 11.3% on its 30% equity layer and in the

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<sup>30</sup> The 2003 NEB return on equity was announced December 5, 2002.

<sup>31</sup> For 2003, see letter L-46-02 dated November 21, 2002 and for 2002, see letter L-43-01 dated November 26, 2001.

<sup>32</sup> The May 26, 2003 rate for series B114016.

<sup>33</sup> Using the NEB formula, which is the more generous than the BCUC formula in periods of low interest rates, to arrive at an 11.5% ROE for 2004, the 10-year forecast yield would need to rise from the 5.50% rate used in the 2002 calculation to approximately 7.78%, assuming that the 10 to 30 year spread is held constant at 48 basis points. To achieve an average 11.5% ROE for the years 2003 and 2004 under the NEB formula, similar to the return the applicant seeks, the 2004 return under the NEB formula would need to rise to approximately 13.21% which would require the 10-year forecast yield to rise approximately 456 basis points from the 5.50% rate used in the 2003 calculation to approximately 10.06%. At an interest rate of 10.06% the equity risk premium would be approximately 267 basis points.

1 U.S. it is allowed 10.7% ROE.<sup>34</sup> Maritimes & Northeast is allowed a 13% return  
2 on its 25% equity layer for its first 5 years ending in 2004.<sup>35</sup> These rates of return  
3 were determined in the recognition that Alliance and Maritimes & Northeast were  
4 new pipelines facing different risks and were negotiated in advance of the  
5 construction.

6 For the sake of contrast between the ATCO Pipelines' request for a 11.5% ROE, I  
7 compared that request to the allowed returns of some local gas and electric  
8 utilities and found that most had been awarded returns in the 9.375% to 10%  
9 range<sup>36</sup>.

10 **Q.14 Do you agree that there have been significant changes in financial markets**  
11 **since the equity risk premium was determined for 1997<sup>37</sup>?**

12 A It would be difficult to argue that there have not been significant changes in the  
13 financial markets over the last few years. Investors are all too well aware of the  
14 term "irrational exuberance"<sup>38</sup> and the disclosures surrounding the accounting at  
15 Enron, WorldCom and Global Crossing. With all those changes, in some respects  
16 we have returned to equity market levels similar to that earlier time. In 1997, the

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<sup>34</sup> Alliance Pipeline Limited Partnership, Bond Rating DBRS, June 28, 2002, page 3. Mr. McCormick is of the view that the returns to investors which may be available in other countries are relevant to the Canadian capital markets and are reflected in the daily trading prices of Canadian securities. The returns on foreign securities to a Canadian investor may be affected by changes in currency exchange rates, withholding taxes, local and foreign tax incentives, access to information and other factors.

<sup>35</sup> Maritimes & Northeast Pipeline Limited Partnership, Bond Rating DBRS, August 26, 2002, page 3.

<sup>36</sup> While not intending to be exhaustive, in July 2002, the BCUC allowed PNG, which had applied to increase the risk premium spread over the benchmark rate, equity returns of 9.63% and 9.88% on segments of its operations. Gaz Metropolitan, which is the subject of an incentive arrangement, was awarded 9.67% for 2002 with an incentive of 0.02%. For 2002, Enbridge Consumers Gas was entitled to 9.66% under the OEB formula. There are awarded rates outside this range, an example of which would be Newfoundland Power which was awarded 9.05% for 2002. For 2003, Gaz Metropolitan was allowed a rate of 10.34%, including the 9.89% formula return and 0.45% incentive for expected productivity gains. Union Gas is under a multi-year performance based regulation arrangement. In Schedule 2 and 9 to the Prepared Testimony of Kathleen C. McShane, the applicant provides statistics on the 2001 capital structures of certain of these firms and those allowed under certain decisions.

<sup>37</sup> See page 21 of 63 lines 24 to 31, page 22 of 63 lines 2 to 8, and the discussion on page 34 of 63 beginning at line 17, 2003-2004 General Rate Application, Prepared Testimony of Kathleen C. McShane.

<sup>38</sup> While not necessarily the first use of the term, please see the remarks of Mr. Alan Greenspan on December 5, 1996, found at <http://www.federalreserve.gov/boarddocs/speeches/1996/19961205.htm>. We note that the period during which Mr. Greenspan was expressing concern about "irrational exuberance" began contemporaneously with or before the 1997 period the applicant has used as its base for changes in financial markets.

1 TSE 300 index began the year at 5,927 and ranged from 5,679 to 7,210. The  
2 index hit a high of 11,388.8 in 2001 and has since retreated to a level of  
3 approximately 5,635<sup>39</sup> as the renamed S&P/TSX composite index. On December  
4 27, 2002, the index had returned to 6,595. On May 21, 2003, the index closed at  
5 6,726. The performance graph in the Management Proxy Circular for Canadian  
6 Utilities, dated March 5, 2003, gives us an indication of the relative performance  
7 of the gas and electrical utilities subindex to the broader market<sup>40</sup>. This period  
8 witnessed a dramatic rise and fall in the prices of technology stocks which have  
9 been described by some commentators as a bubble. During this period, there has  
10 also been a tremendous growth in the number of income funds and trusts listed on  
11 Canadian stock exchanges.

12 On the debt side, investors will be well aware that interest rates have fallen. The  
13 monthly data for Government of Canada marketable bonds over ten years<sup>41</sup>  
14 provided average yields during 1996 that ranged between 6.42% and 8.07%.  
15 During 1997, they ranged from 5.78% and 7.07%. In 1998, they ranged between  
16 5.08% and 5.78%. During 2003, the Government of Canada marketable bonds  
17 over ten years have ranged from 4.90% to 5.60% and are currently 4.90%.

18 The monthly data for Government of Canada real return bonds<sup>42</sup> provided yields  
19 during 1996 that ranged between 3.97% and 4.99%. During 1997, they ranged  
20 from 3.95% and 4.34%. In 1998, they ranged between 3.85% and 4.17%. During  
21 2003, the Government of Canada real return bonds have ranged from 2.79% to  
22 3.32% and are currently 2.93%.

23 Having noted the “round trip” in the equity markets and the falling interest rates, I  
24 must say that these changes in broad indices do not mean that I accept the

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<sup>39</sup> October 9, 2002 close.

<sup>40</sup> For the period December 1997 to December 2002 the gas and electrical utilities subindex is shown as outperforming the TSX Composite by a ratio of 133 to 107. The Management Proxy Circular for Canadian Utilities is incorporated into the record through CAL-AP-20(c).

<sup>41</sup> Bank of Canada Series B14013 provides monthly data, series B114022 provides daily data. Using the monthly series slightly compresses the range for each year since highs and lows may occur on days other than the final day of the month.

<sup>42</sup> Bank of Canada Series B14081 provides monthly data, series B114018 provides daily data.

1 proposition that ATCO Pipelines' has been disadvantaged by changes in the  
2 capital markets. In my view, these events do not provide sufficient support for the  
3 requested increase in the equity risk premium sought by the applicant.

4 **Q.15 Is there other market information which you considered relevant to the issue**  
5 **of required return on equity capital?**

6 A There are three areas of market information which I would like to like to add to  
7 the record. These three are, the increasing investor interest in income funds and  
8 trusts, the reversal of the major gains earned by technology stocks in the last few  
9 years, and, the implications arising from the recent acquisition activity involving  
10 utilities.

11 The first aspect, that I thought relevant to the issue of required returns on equity  
12 capital, was the growth in recent years in the market for trusts and income funds.  
13 These securities pay out a high proportion of the cash flow generated by the  
14 underlying assets, an amount which is often in excess of the income earned. As  
15 such, for tax purposes the distribution can be, in part, a return of capital. At the  
16 end of 1996, there were approximately 37 of these trusts and funds listed on the  
17 TSE. By March 2003, there were over 150 listed on the TSX. The market  
18 capitalization of the issued units of these trusts and funds had risen from just over  
19 \$7 billion at the end of 1996 to just over \$48 billion by March 2003, a compound  
20 annual growth rate of over 35%. The largest fund at the end of 1996 had a market  
21 capitalization of just over \$700 million. By March 2003, there were thirteen  
22 funds which had a market capitalization greater than that of the largest fund in  
23 1996, three of which<sup>43</sup> each had over \$2 billion in market capital, and the 3 largest  
24 trusts or funds exceeded the total market capitalization of all the 37 trusts which  
25 had existed at the end of 1996. In these 75 months, over 120 new trusts or funds  
26 were launched and while the process of bringing new trusts to market may ebb  
27 and flow, it does not seem to have stopped.<sup>44</sup> Clearly, these investment vehicles

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<sup>43</sup> The 3 largest trusts were Enerplus, Canadian Oil Sands and RioCan.

<sup>44</sup> During the same period, a number of funds or trusts were consolidated. In recent months, new listings of income funds or trusts on the Toronto Stock Exchange have included, the Custom Direct Income Fund

1 attracted a great deal of new capital in recent years. With the May 26, 2003  
2 announcement by Enbridge, that it intends to establish an income fund based on  
3 its 50% investment in the Canadian portion of the Alliance Pipeline along with  
4 some of its Saskatchewan assets, it appears that these vehicles are continuing to  
5 attract capital.

6 The table below presents the return on average equity earned by certain electrical  
7 generation and pipeline income funds during 1998, 2002, their recent distribution  
8 yields and market capital.<sup>45</sup>

Fund	1998 Return	2002 Return	Yield	Market Capital \$000,000
Algonquin Power Income Fund	3.5%	3.5%	9.9%	\$ 627
Clean Power Income Fund <sup>46</sup>		3.7%	10.2%	\$ 304
Great Lakes Hydro Income Fund <sup>47</sup>		6.6%	7.8%	\$ 741
Northland Power Income Fund	5.6%	8.2%	8.5%	\$ 415
Pembina Pipeline Income Fund	3.5%	7.9%	9.0%	\$ 1,091
Average	4.2%	6.0%	9.1%	

9 While the earned return of each fund will vary based on a host of factors,  
10 including business cycles and commodity prices, none of the funds in the table  
11 above earned a return on equity equal to that sought by the applicant. None of  
12 these funds pay a pre-tax yield, which includes a partial return of capital, equal to  
13 the 11.5% after tax return sought by the applicant, and in some cases these  
14 distributions are up to 85% currently taxable.<sup>48,49</sup> For the 12 months ended

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[ \$110 million], Paramount Energy Trust, ACS Media Income Fund [ \$110 million], Sleep Country Canada Income Fund [ \$135 million], Specialty Foods Group Income Fund [ \$201 million], Boyd Group Income Fund [ \$9 million], Amtelecom Income Fund [ \$60 million], Fording Canadian Coal Trust. These new listings are only a partial list and do not include the additional issues of a large number of existing income funds and trusts.

<sup>45</sup> The funds selected were listed in a recent National Post article "Betting on a Shrinking Resource" published on November 13, 2002, and included all the power and pipeline funds listed therein having approximately 12 months operating history. The yield was calculated as the annualized value of the latest distribution divided by a mid day price on May 20, 2003.

<sup>46</sup> Clean Power Income Fund was established in October 2001.

<sup>47</sup> Great Lakes Hydro Income Fund was established in September 1999.

<sup>48</sup> By way of example, Pembina has indicated that approximately 85% of 2002 distributions will be taxable. In February 2003, Northland's web site was estimating that 65% of its 2003 distributions would be taxable as business income, with 35% as a return of capital. In February 2003, Great Lakes Hydro's web site was estimating that 60% of its distributions would be taxable as business income, with 40% as a return of capital and tax deferred. Algonquin Power has indicated the approximately 50% of its distributions will be taxable in both 2002 and 2003. Not all funds provide estimates of future tax deferral characteristics.

1 December 2002, these funds earned between 3.5% and 8.2%, in all cases less than  
2 the 11.5% return sought by the applicant. Without earning the return which the  
3 applicant seeks, many of these funds have been able to attract capital.<sup>50</sup>

4 If one were to assume that the market's required equity return was in the  
5 neighborhood of the 11.5% after tax return sought by the applicant, or even the  
6 9.4% to 9.8% returns currently allowed under the BCUC and NEB formulas, it  
7 might follow that income trusts averaging a rate of return of approximately 6%  
8 should be trading at a discount to book value. The table below sets out the market  
9 to book ratio of each of the income funds in the table above, calculated using the

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<sup>49</sup> The calculation of the after-tax return to a taxable Ontario resident Pembina investor assuming a one-year ownership, in a taxable account with the disposition at the acquisition price, and ignoring transaction costs, is as follows:

Pembina Distribution	9.00%		
Percent Currently Taxable	85%		
Ontario Tax Rate for 2002	46.41%		for other income
Capital Gains Inclusion	50%		
	Taxable	Capital	
	Portion	Portion	Total
Pre Tax Return	7.65%	1.35%	9.00%
After Tax Portion	53.59%	76.80%	
After Tax Return	4.10%	1.04%	5.14%

January 2002, trading in the Pembina units opened at \$11.31, and in December 2002, trading in Pembina units closed at \$10.90

<sup>50</sup> The Algonquin Power Income Fund filed a prospectus for \$85.1 million in trust units in October 2002, filed a prospectus for \$75.2 million in trust units in October 2001, filed a prospectus for \$65.3 million in trust units in June 2001, and filed a prospectus for \$65.0 million in trust units in January 2001. The Clean Power Income Fund filed a prospectus for \$75.5 million in subscription receipts for trust units in October 2002 and for \$187.9 million in trust units in November 2001. The Great Lakes Hydro Income Fund filed a prospectus for \$205.8 million in trust units in May 2002 and for \$141.4 million in trust units in December 2001. The Northland Power Income Fund a preliminary prospectus for \$65.0 million in trust units in February 2003. The Pembina Pipeline Income Fund filed a prospectus for \$87.5 million in trust units and \$87.5 million principal amount of convertible debentures in November 2001 and \$60 million principal amount of convertible debentures in March 2001. In addition to prospectus offerings, Pembina established a Distribution Reinvestment Plan in January 2003, and estimated that it would issue \$24 million in equity in 2003 under that plan. In addition to the power income funds listed in the table, the Boralex Power Income Fund filed a prospectus for \$250 million in trust units in February 2002, and the Calpine Power Income Fund filed a prospectus for \$230 million in trust units in August 2002. In some of the issues, the demand was sufficient to allow the underwriters to exercise an over-allotment right. By way of example, as a result of the over-allotment being exercised, the Calpine issue achieved \$264 million proceeds, and the Algonquin Power issue of October 2002 closed with \$98.5 million gross proceeds. The over-allotment in the Northland Power issue for \$65.0 million in trust units, in March 2003, increased the issue size to approximately \$75 million.

1 quarter end market prices<sup>51</sup>. Clean Power, the most recently created income fund  
2 of the sample, which began trading in mid November 2001, is trading the closest  
3 to book value. The market prices and the history of issues by these funds, in my  
4 opinion, make a significant statement about the adequacy of single digit returns  
5 on equity in the current market.

Fund	Dec-01	Mar-02	Jun-02	Sep-02	Dec-02	Mar-03
Algonquin Power Income Fund	1.3 x	1.2 x	1.2 x	1.3 x	1.2 x	1.1 x
Clean Power Income Fund	1.0 x	1.1 x	1.1 x	1.2 x	1.1 x	1.1 x
Great Lakes Hydro Income Fund	1.3 x	1.4 x	1.3 x	1.3 x	1.4 x	1.5 x
Northland Power Income Fund	1.5 x	1.4 x	1.5 x	1.5 x	1.5 x	1.3 x
Pembina Pipeline Income Fund	1.3 x	1.3 x	1.4 x	1.4 x	1.4 x	1.4 x
Average	1.3 x	1.3 x	1.3 x	1.3 x	1.3 x	1.3 x

6 In the various proceedings before this Board this year in which I have presented  
7 capital markets based evidence using income funds as examples, the applicants, in  
8 rebuttal, have offered a range of comments on the subject of income funds. To  
9 assist the development of the record in this proceeding, I thought that I would  
10 address three of the objections that were raised in articles filed in rebuttal  
11 evidence<sup>52</sup> in other proceedings, including the propositions that “Americans  
12 don’t” buy income funds, investors “may be lucky” to get their return “for a year  
13 or two”, and “institutions do not purchase income funds”.

14 *“Americans don’t” buy income funds*

15 With respect to the first proposition, “Americans don’t” buy income funds, the  
16 best source of data on this point may well be the TSX Review which provides  
17 trading data on interlisted securities on a monthly basis. The table below shows  
18 the increasing proportion of foreign trading in each of the four interlisted income

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<sup>51</sup> Market to book ratios and yield calculations are used by research analysts in assessing whether to recommend the purchase or sale of securities. Other valuation criteria including earnings or cash flow, for a regulated entity, allowed to earn a return on its rate base, are often a function of the allowed return, the rate base, and some other factor including the proportion of income retained or distributed.

<sup>52</sup> In the April 1, 2003, ATCO Electric Rebuttal Evidence, two articles were attached, see page 32 of 53 and Attachments B and C.

1 funds, the unit volume, the value of units traded, and the recent market  
2 capitalization of these funds.

2003 Trading to April 30th By Exchange <sup>53</sup>								Total	
Fund	Volume	Value (m)	TSE	NYSE	AMEX	NQ	Other	Foreign	
Enerplus	32,336,631	\$ 911,177	37.5%	46.6%		15.8%		62.4%	
NCE Petrofund	18,466,970	\$ 213,650	44.8%		29.8%	25.3%	0.1%	55.2%	
Pengrowth	38,880,972	\$ 570,690	69.2%	26.9%		3.5%	0.4%	30.8%	
Provident	41,348,368	\$ 448,062	62.7%		37.3%			37.3%	
		\$2,143,579							
		51.9%	\$1,113,259	Value on TSE					
		48.1%	\$1,030,320	Value on other exchanges					

2002 Trading By Stock Exchange <sup>54</sup>								Total	
Fund	Volume	Value (m)	TSE	NYSE	AMEX	NQ	Other	Foreign	
Enerplus	67,527,598	\$1,829,736	46.7%	42.1%		11.2%		53.3%	
NCE Petrofund	42,354,247	\$ 508,906	61.2%		28.8%	9.9%		38.8%	
Pengrowth	48,402,172	\$ 709,929	78.5%	19.6%		1.8%	0.1%	21.5%	
Provident	50,276,548	\$ 534,342	75.3%		19.7%	5.0%		24.7%	
		\$3,582,913							
		59.3%	\$2,125,591	Value on TSE					
		40.7%	\$1,457,322	Value on other exchanges					

Fund	Units	Market Capital (m)	Recent Close	
Enerplus	83,571,521	\$2,396,831	\$28.68	Listed on NYSE November 2000
NCE Petrofund	54,148,799	\$ 605,925	\$11.19	Listed on AMEX October 2000
Pengrowth	111,020,834	\$1,606,471	\$14.47	Listed on NYSE April 2002
Provident	57,839,844	\$ 619,465	\$10.71	Listed on AMEX June 2001
		\$5,228,692		

3 The statement that “Americans don’t” buy income funds is simply wrong. The  
4 table above demonstrates that foreign trading in these income funds exists and has  
5 increased from the 2002 trading volumes and values. In the case of Enerplus, the  
6 2002 trading on foreign exchanges was 53.3% of the total trading, and for the first  
7 4 months of 2003, foreign trading had increased to 62.4% of the total trading. In  
8 aggregate, approximately \$1.4 billion in trading value of these funds went through  
9 foreign exchanges in 2002 and in the first 4 months of 2003, these funds have  
10 enjoyed over \$1 billion in foreign trading. The data in the table above is restricted

<sup>53</sup> See TSX Review April 2003, Blue pages 51 and 52.

1 to interlisted funds, but foreigners remain able to, and do, purchase income funds  
2 that are listed only in Canada.

3 Clearly, not every Canadian income fund or trust has chosen to list on foreign  
4 international exchanges. For many funds, the Canadian capital markets are  
5 sufficient. For smaller funds or funds that are in areas of endeavour which are  
6 well represented in the trading securities in other markets, there is little advantage  
7 to attempting to attract interest in foreign markets. For some of the larger funds  
8 the requirement to maintain the majority ownership by Canadian resident  
9 investors represents an impediment to seeking a foreign listing. These four  
10 interlisted funds, as they are attracting foreign capital, apparently provide  
11 diversification that is attractive to that foreign capital.

12 *Institutions do not purchase income funds*

13 With respect to the erroneous second proposition, that institutions do not purchase  
14 income funds, there is also ample evidence to demonstrate that this is wrong.  
15 There is increasing interest from institutional investors which will from time to  
16 time hold positions in the various funds. The February 4, 2003 article by Mr.  
17 Barry Critchley published in the Financial Post in discussing a recent issue by  
18 Calpine Power Income Fund notes that Ontario Teacher's Pension Plan<sup>55</sup> was one  
19 of the institutional investors participating in that financing in which "more than a  
20 dozen such investors loaded up on the offering".

21 One category of institutional investor is mutual fund managers. The members of  
22 the Investment Funds Institute, who make up a large number of the mutual fund  
23 managers, manage over 1,000 mutual funds. There are over 100 income funds and  
24 trusts listed on the Toronto Stock Exchange. An exhaustive search to discover the  
25 full extent of ownership of each of these mutual funds in each of these income  
26 funds would be time consuming and, since much of the data is not published,  
27 would be undoubtedly incomplete. Such a search would only cover one category

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<sup>54</sup> See TSX Review December 2002, Blue pages 53 and 54.

<sup>55</sup> The Ontario Teacher's Pension Plan web site disclosed net assets of \$66.2 billion as at December 2002.

1 of institution. Obtaining data on the ownership of income funds and trusts from  
2 other categories of institutional investors would be even more difficult.

3 There are a number of data sources that attempt to monitor the changes in  
4 portfolios of various mutual funds. All data sources suffer from the problem of  
5 timeliness since there is often a lag in reporting positions by investors.

6 Bloomberg provides certain information with respect to published holders of  
7 equities. For each issuer, a Bloomberg subscriber might access Bloomberg data at  
8 EQUITY HDS. Targeted Inc. supplies some data of this type to its subscribers  
9 and the Stockwatch subscribers.

10 As part of the preparation for filing evidence in the recent AltaLink application,  
11 on January 8, 2003, I assembled some data on fund ownership. On that date,  
12 Stockwatch identified over 100 holders of Canadian Oil Sands Trust units. The  
13 holders identified held in aggregate nearly 19 million units and represented  
14 approximately 33% of the approximately 57.7 million units then outstanding.  
15 Franklin Mutual Advisors was shown as holding over \$100 million in units. A  
16 United States based fund, Capital World Growth & Income fund, was shown to  
17 have over 1.7 million units. Among the identified holders, many of which were  
18 well known Canadian mutual funds groups, were certain Trimark funds (\$100  
19 million), certain CI funds (\$53 million), certain Guardian funds (\$78 million) and  
20 certain TD funds (\$49 million).

21 On January 8, 2003, Stockwatch indicated that there were over 40 holders of  
22 Pengrowth Energy Trust units. Among the identified holders each of whom were  
23 ascribed holdings in excess of \$2 million, were the Bankmont Financial Corp. (\$7  
24 million), CI Signature High Income Fund (\$7 million), DKR Management  
25 Company Inc., Guardian Monthly High Income Fund (\$28 million), Royce &  
26 Associates Inc. (\$11 million), Spinner Asset Management LLC, TAL Global  
27 Asset Management, and TD Asset Management.

28 On January 8, 2003, Stockwatch indicated that among the holders of Algonquin  
29 units we would find mutual fund managers including Guardian and Elliott &

1 Page. AIM Canadian First Class fund<sup>56</sup> and the CIBC Dividend fund<sup>57</sup> were  
2 shown as large holders of Clean Power Income Fund Trust units. Guardian funds  
3 and the Renaissance Canadian Income Trust mutual fund were also shown as  
4 holders of the Great Lakes units. The Renaissance Canadian Income Trust mutual  
5 fund was shown as a significant holder of Northland Power. Guardian<sup>58</sup>,  
6 Renaissance<sup>59</sup>, Bissett<sup>60</sup>, AGF and Elliott & Page are all shown as investors in the  
7 Pembina Pipeline Income fund.

8 Institutional demand for income trust and fund products has existed for many  
9 years, as can be seen from a search for the inception dates of some of the mutual  
10 funds<sup>61</sup> that target these investments. Another example would be the October 23,  
11 2001 press release of Viking Energy Royalty Trust “which completed a private  
12 placement with a group of institutional investors”. Block trading statistics are  
13 also an important indicator of institutional interest. Income fund block trading has  
14 risen from approximately \$4.9 billion in 1999 to approximately \$14.9 billion in  
15 2002.<sup>62</sup>

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<sup>56</sup> On January 8, 2003, the AIM funds web site showed the Clean Power Income fund as the second largest of the top 10 holdings in the AIM Canadian First Class fund, representing 3.36% of that fund.

<sup>57</sup> On January 8, 2003, the most recent financial statements for the CIBC Dividend fund available on the internet showed the Clean Power Income fund as representing over 2% of the approximately \$400 million of assets of that fund.

<sup>58</sup> As of November 30, 2002, Pembina Pipeline Income fund units represented 2.6% of the \$1.167 billion of assets of the GGOF Monthly High Income Fund. As of April 30, 2003, pipeline and power trusts represented 10.9% of the value of this fund. This fund was capped in October 2002 and a new fund GGOF Monthly High Income Fund II was established.

<sup>59</sup> As of December 31, 2002, Pembina Pipeline Income fund units represented 5.4% of the assets of the Renaissance Canadian Income Trust mutual fund, the third largest of the top 10 positions disclosed (excluding cash). In February 2003 this fund was capped at \$600 million and a new fund was established, Renaissance Canadian Income Trust II.

<sup>60</sup> As of April 30, 2003, Pembina Pipeline Income fund units represented .511% of the assets of the Bissett Income Fund, the largest of the top 10 positions disclosed. In November 2002 this fund was capped.

<sup>61</sup> One such example is the GGOF Guardian Monthly High Income mutual fund, which shows an inception date of October 21, 1996. The investment strategy of the fund focuses on “investing in trust units” as well as fixed income securities. The GGOF Guardian Monthly High Income Fund claims assets in excess of \$1.1 billion. Another example is the Renaissance Canadian Income mutual fund, which shows an inception date of October 1997. This mutual fund “invests in a diversified portfolio of income trusts, royalty trusts and real estate investment trusts.” The Renaissance Canadian Income fund claims assets of approximately \$600 million.

<sup>62</sup> See page 6 of the publication Income Fund Market 2002 Year in Review, CIBC World Markets.

1           Should any further evidence be required, perhaps the fact that a single institution  
2           in February 2003 purchased \$325 million of units, of one income trust, in a single  
3           private placement should finally put to rest this erroneous proposition.<sup>63</sup>

4           *Investors “may be lucky” to get their return “for a year or two”.*

5           With respect to the third erroneous proposition, that investors “may be lucky” to  
6           get their return “for a year or two,” there is also ample evidence to demonstrate  
7           that this is wrong. To begin with examples of trusts which have been in business  
8           for a great many years, Pengrowth, an oil related income fund established in the  
9           1980s and originally issued at \$10.00, achieved a price of nearly \$22.00 in 2001.  
10          Pengrowth has paid distributions aggregating \$23.40 as at February 15, 2003.  
11          The 2002 distributions for Pengrowth were 22% currently taxable. Enerplus,  
12          another oil and gas income fund established in 1985, is trading at \$31.16 as this  
13          evidence is being prepared. As it is the amalgamation of several other income  
14          funds that were initially issued at prices of \$10.00 per trust unit, the calculation of  
15          distributions since inception would vary for each series of pre-amalgamation  
16          units. The Enerplus web site gives distribution information for the period 1990 to  
17          date. Distributions over that period have totaled \$47.86 per trust unit. The 2002  
18          distributions for Enerplus were 34% tax deferred.

19          Three of the five income trusts which I have chosen as the most relevant sample  
20          have been in operation since at least 1998. Pembina had distributed \$5.10, over  
21          half its initial issue price, by the end of 2002. Its prospects for the continuation of  
22          distributions are of course based on the productivity and life of its assets. One of  
23          its assets, which was acquired at a premium, is the Alberta Oil Sands Pipeline,  
24          which earns a return determined with reference to the NEB formula<sup>64</sup>, under a  
25          contract to 2035. Northland has distributed \$5.03 since inception. Algonquin has

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<sup>63</sup> See the February 27, 2003 Canadian Oil Sands Trust press release with respect to the acquisition of certain interests in Syncrude from Encana for consideration in excess of \$1 billion, which disclosed “The remainder of the equity was financed through a private placement of trust units with a large institutional investor for approximately Cdn \$325 million.” [emphasis added]

<sup>64</sup> See note 3 to the Alberta Oil Sands Pipeline financial statements filed as part of the Pembina Pipeline Income Fund 2001 Annual Information Form.

1 paid out \$4.85, almost half its original cost. Even the funds with shorter histories  
2 have repaid a material portion of the initial purchase price.<sup>65</sup>

3 It should now be clear, that income funds, attract capital from retail and  
4 institutional investors, Canadian and international investors, and have long  
5 histories of distributing cash flow to their investors.

6 **Q.16 Are income funds in the electrical generation and pipeline business of**  
7 **comparable business and financial risk to the ATCO Pipelines?**

8 A My evidence related to income funds is important since it provides real world data  
9 on a segment which has been eminently successful in attracting capital. The test  
10 of a reasonable or fair return in the Hope Natural Gas case quoted above is a little  
11 more complex than just attracting capital. That test refers to “corresponding  
12 risks” and raises the question of whether the business risks faced by these income  
13 funds are in any way comparable with the risks faced by the Applicant. Calgary  
14 will be addressing the relative risks of various classes of regulated enterprise in its  
15 evidence. I do not intend to repeat their analysis here.

16 I would note that the business risk of ATCO Pipelines has been considered in  
17 prior hearings and in recognition of these risks ATCO Pipelines South was  
18 awarded a 45.5% equity layer. That layer is similar to that determined as  
19 appropriate in U99099 for electrical generation assets.<sup>66</sup>

20 Several of the income funds and trusts I chose as examples had investments in the  
21 electrical generation business and one was in a the pipeline business, both of  
22 which are lines of endeavor that will be familiar to this Board. Investors, or their  
23 advisors, are aware of the cornucopia of investment alternatives. They will be  
24 aware and will weigh choices between enterprises in similar industries. Investors  
25 have the choice to choose Pembina Income Fund or TransCanada to obtain  
26 varying degrees of exposure to the range of pipeline based investments and the  
27 risk that management will unwisely diversify into unprofitable lines of endeavor.

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<sup>65</sup> Great Lakes has paid out \$3.97 since its initial financing closed in November 1999.

<sup>66</sup> See the discussion at page 256 related to EPGI, and TransAlta Genco at page 333 and 337.

1 Investors may chose Northland Power or Canadian Utilities for varying degrees of  
2 exposure to the range of electric investments. When we examine the trusts'  
3 market to book ratios we see an average of approximately 1.3 times for firms  
4 earning an after tax return of approximately 6% and distributing to their investors  
5 a pre-tax payment of approximately 9%. When we examine the market to book  
6 ratios of companies with substantial regulated utility investments, upon which  
7 they are earning formula based returns of approximately 10% we find market to  
8 book ratios approaching 2 times.

9 The financial risk of ATCO Pipelines relative to my sample of income funds will  
10 differ due to the differences level of debt<sup>67</sup> and preferred instruments in their  
11 respective capital structures, but is increased from the relative levels suggested  
12 solely by the specific levels of debt by two policies particular to income funds.  
13 The first of these income fund policies, is the policy to pay out high levels of  
14 distributions, and the second is to incur debt to make distributions when the  
15 distributable cash would otherwise be inadequate to maintain the anticipated  
16 level. As a result of these policies, income funds are generally returning capital to  
17 their investors and therefore, relative to utility equities offer investors low to

<sup>67</sup> The table below sets out the long term obligations and unitholders' equity of the sample funds, as at March 31, 2003. The calculation ignores the deferred items and in one case a \$150 acquisition facility.

	Algonquin	Clean Power	Great Lakes	Northland	Pembina
Long Term Liabilities	\$ 168,239	\$ 84,014	\$ 319,310	\$ 49,801	\$ 350,807
Levelization Amounts		\$ 11,400			
Other	\$ 9,470				
Minority Interest	\$ 13,997				
Convertible Debentures					\$ 71,744
Unit Holders Equity	\$ 528,690	\$ 275,700	\$ 497,510	\$ 297,181	\$ 653,125
<b>Total Long Term Liabilities &amp; Equity</b>	<b>\$ 720,396</b>	<b>\$ 371,114</b>	<b>\$ 816,820</b>	<b>\$ 346,982</b>	<b>\$ 1,075,676</b>
Long Term Liab.to Equity	32%	30%	64%	17%	54%
Average of 5 Trusts	39%				
All Above Liability Items/Equity	36%	35%	64%	17%	65%
Average of 5 Trusts	43%				
Great Lakes including acquisition bridge facilities of \$150 million			94%		
All Above Liabilities to Total	27%	26%	39%	14%	39%
Average of 5 Trusts	29%				

1 moderate growth and capital appreciation. The table below shows the 2002 price  
2 change and the recent capital appreciation (if any) for each of the funds since their  
3 inception.

Income Fund Price Appreciation	31/12/01	31/12/02	Change	Change	Since Inception <sup>68</sup>
<b>Algonquin Power Income Fund</b>	<b>\$ 10.40</b>	<b>\$ 9.28</b>	<b>\$ (1.12)</b>	<b>-10.8%</b>	<b>-1.5%</b>
<b>Clean Power Income Fund</b>	<b>\$ 10.31</b>	<b>\$ 9.50</b>	<b>\$ (0.81)</b>	<b>-7.9%</b>	<b>-4.5%</b>
<b>Great Lakes Hydro Income Fund</b>	<b>\$ 13.40</b>	<b>\$ 15.23</b>	<b>\$ 1.83</b>	<b>13.7%</b>	<b>13.0%</b>
<b>Northland Power Income Fund</b>	<b>\$ 11.60</b>	<b>\$ 11.00</b>	<b>\$ (0.60)</b>	<b>-5.2%</b>	<b>2.0%</b>
<b>Pembina Pipeline Income Fund</b>	<b>\$ 11.31</b>	<b>\$ 10.90</b>	<b>\$ (0.41)</b>	<b>-3.6%</b>	<b>2.7%</b>
			<b>Average</b>	<b>-2.8%</b>	<b>2.3%</b>

4 In one other respect, income funds may have higher risks than utility equities. At  
5 the present time, investors in income funds may perceive that there is some  
6 increased risk as a result of the lack of statutory limitation of liability to the  
7 invested capital which exists for shareholders in public companies. Ontario has  
8 tabled legislation to expand the statutory protection to these investors and the  
9 issue appears to be under consideration in other jurisdictions. In spite of the lack  
10 of a specific statutory protection, many income trusts have complex structures  
11 which involve limited liability companies, thereby isolating some of these  
12 potential risks. The existence of these risks has not been sufficient to stem the  
13 tide of capital to income funds.

14 **Q.17 Will you comment on the recent reversal of the major gains earned by**  
15 **technology stocks, the second aspect which you considered relevant to the**  
16 **issue of required return on equity capital?**

17 The second aspect that I thought relevant to the issue of required returns on equity  
18 capital in recent years was the reversal of the major gains earned by technology

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<sup>68</sup> The calculation ignores the affect of interest savings on any instalment payment, and is based on a mid day price on May 20, 2003.

1 stocks in the last few years. In short, the returns on information technology stocks  
2 have been dismal. In October 2000, the TSX information technology index hit  
3 levels in excess of 110. In October 2002, the same index fell to levels below 10.  
4 Nortel may be the most famous Canadian example of the irrational exuberance  
5 that some saw gripping the capital markets. In July 2000, its shares were trading  
6 as high as \$123 and in October 2002 they had fallen to prices as low as \$0.69. In  
7 August 2000, Nortel represented 34.59% of the TSE 300 index but by September  
8 2002, it had fallen dramatically and represented only 0.53% of the S&P/TSX  
9 composite index. Since that time, Nortel has recovered and at the end of April  
10 2003 represented approximately 2.33% of the index.

11 I believe that the poor returns on shares of companies in the technology sector is a  
12 factor which makes the returns available under a formula similar to the NEB  
13 adjustment mechanism quite attractive in the current market. The billions of  
14 dollars attracted to the units of the various income funds and trusts, some of  
15 which, as shown in the preceding tables, are not achieving the returns available  
16 under formula similar to the NEB adjustment mechanism, confirms this view.

17 **Q.18 Can you comment on the implications of the purchase of several utilities at**  
18 **material premiums to the underlying book value?**

19 A In recent months there have been a number of acquisitions of companies which  
20 own regulated utilities and regulated utility assets. Many of these acquisitions  
21 have taken place at substantial premiums to the trading market of the shares of the  
22 utility owners or the rate base of the utility assets. I believe paying a substantial  
23 premium for rate base assets indicates that the return on those assets is in excess  
24 of the then market requirement.

25 In March 2002, Duke acquired Westcoast committing approximately U.S. \$8.5  
26 billion.<sup>69</sup> Duke's offer was a cash and share offer valued at approximately \$43.80  
27 per Westcoast share. The market for Westcoast's shares had been approximately

1           \$36 prior to the offer. Westcoast's major assets included, in addition to the NEB  
2 regulated utilities, interests in the Alliance Pipeline, Union Gas and Centra Gas,  
3 and a number of power generation projects. I was interested in comparing the  
4 proposition that the applicant's calculation of widening spreads in utility bonds  
5 justified an 11.5% after tax return equity with the action by Duke in committing  
6 U.S. \$8.5 billion in the purchase of Westcoast. Since Westcoast, in the absence of  
7 a negotiated settlement involving a higher or incentive rate of return, is saddled  
8 with the apparently inadequate NEB adjustment mechanism and ROE, I could not  
9 believe that the synergies and returns on other aspects of their business outweigh  
10 the comparatively<sup>70</sup> low rate of return on Westcoast's NEB regulated pipeline  
11 investments, which Duke acquired as part of the purchase.

12           In November 2002, Terasen acquired a one-third interest in the Express Pipeline  
13 for consideration of approximately \$200 million<sup>71</sup>. In its November 20, 2002  
14 conference call, the officers of Terasen declined to provide a rate of return on  
15 equity when asked to do so by one analyst. They noted that they anticipated  
16 earning \$12 million in 2003 from the investment, operating management fees and  
17 certain tax benefits which were described as "significant". As such, the return on  
18 equity for 2003 appears to be approximately 6% or less. This return is based on  
19 the full through-put volumes which were supported by a commitment of the  
20 vendor to continue to ship volumes above committed capacity for a minimum of  
21 two years. In support of the acquisition, Terasen offered 5.3 million shares to the  
22 market at a price of \$38.00.<sup>72</sup>

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<sup>69</sup> The consideration was originally set out in a September 20, 2001 press release. Duke has subsequently divested of certain of the assets acquired including interests in the Alliance Pipeline and Foothills Pipe Lines.

<sup>70</sup> For clarity, the intended comparison is between the NEB rate and the rate sought by the applicant in this proceeding.

<sup>71</sup> The November 19, 2002, press release reported "The consortium is paying approximately Can \$1,175 million for the Express Pipeline System, including assumed debt of approximately Can \$582 million".

<sup>72</sup> On December 3, 2002, BC Gas (now Terasen) filed a prospectus for an issue of \$201.4 million of common shares. They had also undertaken a private placement of approximately \$100 million of common shares on the same terms to assist in the financing of the Express pipeline purchase. In November 2001, BC Gas filed a prospectus for \$188 million of Subscription Receipts for common shares.

1 In our own province, we have seen the recent AltaLink acquisition of TransAlta  
2 distribution assets<sup>73</sup>. In that transaction, AltaLink paid a premium of  
3 approximately \$200 million for rate base assets of approximately \$644 million.  
4 While we do not currently have an adjustment mechanism determining the return  
5 on equity for Alberta utilities<sup>74</sup>, AltaLink must have been aware of the recent  
6 public record of decisions of the AEUB setting returns on equity<sup>75</sup>. AltaLink is in  
7 the process of applying for AEUB approval of its rates.<sup>76</sup>

8 In May 2003, TransCanada announced the acquisition of the various interests in  
9 the Foothills held by Westcoast for \$105 million plus assumption of debt. The  
10 press release did not provide a market to book calculation. The 2003 Annual  
11 Information Form of Westcoast did disclose that Westcoast held an approximate  
12 27 % interest in the average Foothills rate base, which was carried at December  
13 31, 2002 at a value of approximately \$63.5 million. Assuming no material  
14 variation between the December value and that of the transaction date, the market  
15 price paid would be approximately 1.65 times book. In each of the years from  
16 1996 to 2002, Foothills has achieved the NEB formula allowed rates of return in  
17 that year.

18 In the conference call following its May 26, 2003 announcement of the  
19 establishment of an Enbridge income fund to hold its 50% interest in the  
20 Canadian portion of the Alliance pipeline, Enbridge indicated that it anticipated  
21 that the enterprise value of the new trust would be approximately \$850 million.  
22 The enterprise value is derived from the value of the trust units which will be  
23 issued in the initial public offering. The book value of these assets to Enbridge,  
24 including the premium<sup>77</sup> paid to former owners as part of its acquisitions was

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<sup>73</sup> The transaction was announced in July 2001 and received regulatory approval in March 2002.

<sup>74</sup> A hearing on that matter is contemplated.

<sup>75</sup> These decisions would include the 2000-9 Decision which determined a return on equity of 9.375%, and U99099 (see page 328) which approved a range from 9% to 9.5%. The DBRS Report on AltaLink (CAL-ALP.181(a) in the AltaLink proceeding) also assumed a 9.75% ROE for AltaLink.

<sup>76</sup> In Application No. 1279345, AltaLink has sought a return on equity of 10.75%.

<sup>77</sup> The March 20, 2003, Enbridge press release indicated a purchase of an 11.8% interest in Alliance at a price of approximately 1.1 times book. Enbridge previously had acquired interests from Williams and El Paso described in press releases dated September 23 and November 22, 2002.

1 approximately \$530 million. As such, Enbridge will be realizing an increase in its  
2 value of approximately \$300 million, or over 56%. The full benefit of this  
3 accretion will be realized in stages beginning with the disposition of the 25% to  
4 30% of the trust units anticipated to be later this year. Enbridge indicated that it  
5 would book a capital gain in 2003 of approximately \$150 million as part of the  
6 sale to the trust units. The 2003 capital gain alone represents a premium of  
7 approximately 28% on its book value.

8 These various acquisition and restructuring transactions, taking place at premiums  
9 to book value, in my view are strong evidence of the generosity of the underlying  
10 utility returns and make clear that capital is being attracted on the basis of lower  
11 returns than those sought by the applicant.

12 **Q.19 Isn't it the case that, under the NEB adjustment formula, equity risk**  
13 **premiums increase as the interest rate expectation is reduced?**

14 A Yes, as the table below shows, the equity risk premium increases as the  
15 expectation of interest rates is reduced. From a 3.30% equity risk premium in  
16 1996, the 2002 equity risk premium increased 60 basis points to 3.90% as the long  
17 Canada forecast yield fell 240 basis points from 8.03% to 5.63%. Effectively, the  
18 equity risk premium allowed under the NEB formula increases by about 25% of  
19 the amount of the decrease in forecast interest rates.

		1995	1996	1997	1998	1999	2000	2001	2002	2003
Unadjusted ROE for prior year <sup>78</sup>	A	12.25	11.34	10.67	10.21	9.58	9.90	9.61	9.53	
Long-term 30 Year forecast bond yield prior	B	9.25	8.03	7.14	6.53	5.69	6.12	5.73	5.63	
Average forecast yield 10 year Canadas [Consensus]	C	7.60	6.50	5.95	5.25	6.00	5.85	5.15	5.50	
Average yield diff. Between 10 an 30 year Canadas	D	0.43	0.64	0.58	0.44	0.12	-0.12	0.48	0.48	
Long Canadas 30 Year forecast yield (C+D)	E	9.25	8.03	7.14	6.53	5.69	6.12	5.73	5.63	5.98
Diff. Forecast Long Canadas yield (E-B)	F	-1.22	-0.89	-0.61	-0.84	0.43	-0.39	-0.10	0.35	
Interest Rates and Equity Risk Premium Adjustment (.75*F)	G	-0.92	-0.67	-0.46	-0.63	0.32	-0.29	-0.08	0.26	
Unadjusted ROE for current year (G+A)	H	12.25	11.33	10.67	10.21	9.58	9.90	9.61	9.53	9.79
Rounding to the nearest 25 basis point until 1997			11.25							
Resulting Equity Risk Premium (H-E)	I	3.00	3.30	3.53	3.68	3.89	3.78	3.88	3.90	3.81

20 Under the NEB formula, the maximum equity risk premium would be 5.31%  
21 which would occur when interest rates fell to 0% and the minimum equity risk

1 premium of 0% would occur with the interest rates forecast to achieve a rate of  
2 21.24%.

3 For comparison, the BCUC formula caps the equity risk premium at 350 basis  
4 points for returns derived from forecast interest rates below 6%<sup>79</sup>.

5 **Part II**

6 **Q.20 Do you agree with the comments with respect to changes in spreads between**  
7 **the 30-year Canada bonds and utility bonds, between 1997 to 2002 made in**  
8 **support of the equity risk premium calculations<sup>80</sup>?**

9 A If the implication of the comments made on pages 21 of 63 and 22 of 63 is that  
10 the increase in spreads from 1997 to 2002, for that sample of bonds as calculated,  
11 is support for the proposition that ATCO Pipelines requires an 11.5% return on  
12 equity, I am not in agreement.

13 In this application, unlike the recent ATCO Gas and ATCO Electric applications,  
14 the company has sponsored, as part of its initial evidence, external expert material  
15 dealing with the Discounted Cash Flow and Equity Risk Premium methods. A  
16 discussion of these methods is to be contained in the evidence of Drs. Booth and  
17 Berkowitz to be filed contemporaneously. In the recent ATCO Gas and ATCO  
18 Electric applications, the discussion of the changes in spreads between Canada  
19 bonds and Utility bonds was a central part of the justification for the higher  
20 returns sought by each applicant.<sup>81</sup> In this application, the analysis of increasing  
21 spreads has less prominence, but I believe that it suffers from a number of data  
22 problems. While my concerns have been more fully explored in my evidence  
23 filed in the previous proceedings, I will briefly review some of the concerns with  
24 the data.

---

<sup>78</sup> The difference between 11.33% in line H for 1996 and 11.34% in line A for 1997 was rounding recognized in a later press release.

<sup>79</sup> See page 24 of the August 26, 1999 Decision of the BCUC, "Return on Common Equity for a Benchmark Utility".

<sup>80</sup> See pages 21 of 63, line 22 to page 22 of 63, line 8, 2003-2004 General Rate Application, Prepared Testimony of Kathleen C. McShane.

1           Starting point

2           The result of this type of analysis, linking a conclusion to the change in a variable  
3           over time, is highly susceptible to the choice of starting point. The applicant has  
4           not addressed whether its 1997 base year was a normal year. The applicant  
5           appears to have chosen 1997 in part due to it being nearly the low point in its  
6           calculation of the spread between annual averages of long Canada bonds and a  
7           CBRS A utility series.<sup>82</sup> Had any other starting point been chosen, the results  
8           would have been different and likely led to a lower conclusion. If we begin at the  
9           low point, it is relatively easy to argue for an increase in the compensating  
10          factor.<sup>83</sup>

11          Had we begun this analysis in 1992, when spreads were higher than 1997 but  
12          possibly lower than today, and used the spreads at that time as our base level and  
13          guide for assessing the equity risk premium, the Decisions for 1997 would have  
14          appeared generous relative to those of 1992<sup>84</sup>. Beginning with a 325 basis point  
15          1992 base line, the erosion of 50 to 100 basis points in average annual spreads  
16          should, under this method argue for a reduction of equity risk premium in 1997.

17          The Use of Annual Averages

18          Another of the problems with this method, is that the use of annual averages  
19          obscures the point in time market conditions that existed when rate of return  
20          Decisions were actually made. In 1992, utility spreads were wider in the earlier  
21          part of the year, but the results of any hearing that concluded in the first half of  
22          the year would be compared to bond data, some of which did not exist at the time  
23          of the hearing. The conditions that existed at the time when a rate of return case

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<sup>81</sup> By way of example, see the 2003-2004 General Rate Application of ATCO Electric, pages 27-2 and 27-3.

<sup>82</sup> See CAL-AP-76(m).

<sup>83</sup> See page 22 of 63, lines 15 and 16, Prepared Testimony of Kathleen C. McShane, “the increase in corporate/government bond yield spreads indicates a higher equity risk premium under current capital market conditions.”

<sup>84</sup> In Decision E93004, which was issued in February 1993 after the filing of evidence in April and May 1992, and a hearing in June 1992, the Board allowed 325 basis points, allowing CWNG a return on equity of 12.25%. The Board reached its decision on company specific parameters, and the then current market conditions, not the average annual yield of A rated utility bonds. See page 15 of the decision.

1 was litigated may differ from the annual average, and as such, the comparison of  
2 the annual average interest rate with the equity risk premium allowed in a  
3 particular decision may depend on whether there were any material moves in the  
4 market, subsequent to the decision.

5 Changes in the credit perception of bond issuers

6 There are differences in the spreads at which instruments in each of the  
7 subcategories of the A rating may trade. As such, downgrades for a specific  
8 company within the broad A category may give rise to the appearance of  
9 increasing market risk only because the sample may not be consistent in its credit  
10 mix over time.<sup>85</sup>

11 The market credit perception of a company may also change without any action  
12 being taken by a rating agency. New ventures outside the area of expertise, or  
13 proposed changes in the capital structure of the company may affect the bond  
14 market. In the past year, TransCanada has invested in nuclear power generation  
15 and created a holding company structure to avoid certain restrictions in its  
16 existing trust indentures.<sup>86</sup> These sorts of events do not escape the notice of the  
17 debt markets. It is not clear the extent to which increasing spreads in utility  
18 holding company debt are a function of company specific events unrelated to the  
19 regulated utility.

20 30-year bond market is a narrow market

---

<sup>85</sup> In the attachments to CAL-AP-76, we are given an indication of how important the mix of the various classes of A credits could be. In that reply, for 30-year term debt, the increased spread is indicated as 80 basis points between A(high) and A(low). For 10-year term debt, the increased spread is indicated as 35 to 60 basis points between A(high) and A(low).

<sup>86</sup> An example of a company specific event that may give rise to increasing spreads, would be a proposal by a company to alter or avoid the covenants under the existing trust indentures which govern its debt. TransCanada recently reorganized, creating a holding company above the existing issuer of its debt. The published rationale for the change was “two-fold: to address certain restrictions contained in the terms and conditions of the company's debt, and to provide the company with greater flexibility in how it holds its assets in the future. Some of the company's trust indentures have a covenant, or restriction, that effectively sets a limit on how much TransCanada PipeLines Limited can invest in certain types of assets. If the company exceeds this limit, it would be prohibited from paying dividends.” With the establishment of the new structure, assets may be held and financed in corporations above or equal to the existing borrower.

1 By focusing on the 25 to 30-year maturities, rather than the whole range of longer  
2 term instruments in the 10 to 30-year range the applicant makes the outcome  
3 subject to the changing Canadian government policy for managing its debt, which  
4 recently has focused on reducing the average term of the debt.<sup>87</sup> Not every A  
5 rated utility had issued bonds that would qualify under the 2025 or greater  
6 maturity condition used by the applicant. As such, the market is less robust,  
7 which can be seen from the fact that the Credit Weekly publication does not  
8 provide 30-year indicated spreads for many of the issuers it lists.

9 *Inconsistent data streams*

10 The applicant relies on A rated Utility bond yield data from one source<sup>88</sup>, CBRS,  
11 up to August 2000 and thereafter a second source, the Globe and Mail, without  
12 demonstrating that the second source of data would have provided consistent  
13 information for the earlier period. The treatment of the data point for September  
14 2000 is particularly instructive, since it is the only one overlapping both series.  
15 CBRS published the September 2000 data point as 7.37%. The Foster data point  
16 calculation for September 2000 was 7.09%<sup>89</sup>, and, we were advised in CAL-AP-  
17 76(e) that “The September 2000 data from CBRS appeared to be inconsistent with  
18 the prior months data” and was not used. The prior month CBRS data point was  
19 7.15%, resulting in a monthly change of 22 basis points. It is of interest that there  
20 are instances<sup>90</sup> in the Foster data where the month-to-month change is greater than  
21 22 basis points, but the important point is that there is no proof of the consistency  
22 in the data streams. In addition, in earlier proceedings, applicants using this data  
23 stream were afforded the opportunity to extend it to demonstrate its consistency,  
24 but declined to assemble the data.

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<sup>87</sup> In the 25 to 30 year range, there are two conventional Government of Canada issues, the 5.75% June 1 2029 issue (\$13.9 billion) and the 5.75% June 1, 2033 issue (\$7.2 billion as at December 2002).

<sup>88</sup> The Utility Bond yield data up to August 2000 is identified as CBRS data in CAL-AP-76(a). While the subsequent data is described as being drawn by Foster Associates from information published in certain Monday editions of the Globe and Mail in CAL-AP-76(h).

<sup>89</sup> The data point is shown as 7.09% in attachment CAL-AP-76(d)(g), but 7.10% in the text to CAL-AP-76(e).

<sup>90</sup> See the month to month change from August to September 2001 and June to July 2002.

1 A more serious problem with the data is the inclusion of BBB rated companies in  
2 the later data stream.<sup>91</sup> We see, in attachment CAL-AP-76 (f) that 3 of the 10  
3 issuers were rated BBB+ by S&P in 2001 and 4 of the 10 issuers in the sample are  
4 described as being rated BBB+ by S&P by June 2002.<sup>92</sup> In CAL-AP-76(s), the  
5 applicant allows that it is unlikely that CBRS would have included bonds rated  
6 below A- in an A series, and as such, the data discontinuity is clear. One of the  
7 issuers has been rated in the BBB category by both S&P and DBRS since  
8 December 2002, and for that reason should be excluded from the analysis as it is  
9 no longer representative of A rated issuers of either rating agency.

10 Balance

11 While the applicant attempted to “ensure that the long-term issues of a broad  
12 spectrum of A-rated utilities were represented, but that the data for a single  
13 company did not dominate”<sup>93</sup>, we have noted that about half of the increase in  
14 yields from September 2000 to March 2003 is related to 4 downgraded issuers.  
15 Removing those 4 leaves us with a sample of 6 companies with 3 representing  
16 71% of the outstanding principal amount of bonds in the sample. The increasing  
17 yields of TransCanada and Westcoast, with 6 out of the remaining 16 bonds in the  
18 sample, account for 77% of the remaining increase in yields.

---

<sup>91</sup> While the increase in yields quoted in attachment CAL-AP-76(d)(g) for issues existing from September 2000 to March 2003 averages 38 basis points per issue, the change was not universal. The three Enbridge Consumers Gas issues traded at marginally lower rather than higher yields. Two issues, EPCOR and TransAlta, each of which have been downgraded to BBB+ by S&P and for that reason should not be included in a consistent S&P/CBRS A utility sample, accounted for 188 of the aggregate 582 net basis point change, approximately 32%. Including the other two issues that were downgraded, BC Gas Utility (now Terasen Gas) and Nova Scotia Power, accounts for 285 of the total 582 basis point change, approximately 49%.

<sup>92</sup> For the 10 issuers identified in attachment CAL-AP-76(f) there were downgrades by DBRS in respect of two (Enbridge Consumers and TransAlta) and downgrades by S&P in respect of eight in the period covered by the data Globe and Mail yield data. S&P increased the ratings of Westcoast and Union Gas, but also subsequently returned them to the original rating category. TransAlta was downgraded 2 rating categories from A(high) to A(low) by DBRS and 3 rating categories from A+ to BBB+ by S&P. Currently, three of the 10 issuers in the table had split ratings with one rating in a BBB category while at the beginning all were A rated by both rating agencies. One of the issuers, TransAlta, is now rated in the BBB category by both rating agencies. In attachment CAL-AP-76 the applicant supplies data with respect to varying indicated new issue spreads for a number of issuers in various rating categories which would explain, in part, the increasing spreads over Canada bonds of the firms downgraded by S&P.

<sup>93</sup> See CAL-AP-76 (j).

1           The utility bond sample subsequent to August 2000 excludes a number of issuers  
2           and other issues which would have met the criteria for inclusion, the “A” rating.<sup>94</sup>  
3  
4           In an attempt to quantify the upward bias of the ignoring shorter term issues and  
5           including certain BBB rated issuers in the latter data, on October 1, 2002, I  
6           accessed a data stream published by Bloomberg which estimated A and BBB  
7           Utility bond yields. The table below compares the October 1, 2002, 10, 20 and 30  
8           year indicated yields to the result calculated for September 30, 2002 in CAL-AP-  
9           76 (d) & (g), suggesting the ATCO Pipelines data has an upward bias of  
10          approximately 74 basis points against the average of the 10, 20 and 30-year terms  
11          and 43 basis points (7.27-6.84= 0.43) compared to just the 30-year A yield  
            calculated by Bloomberg.

	Term	A	BBB <sup>95</sup>	
Bloomberg	10	6.13	6.48	.35
	20	6.61	7.30	.69
	30	6.84	7.43	.59 <sup>96</sup>
	average	6.53	7.07	
Sept 02 schedule CAL-AP-76(g)		7.27		
	variance		.74	

12          Other indications of the upward bias of the inclusion of 4 issuers rated BBB by  
13          S&P in the sample of “A” utilities can be found in the reply to CAPP-76 that in  
14          the U. S. market the spread between A and BBB, for an unspecified term, would  
15          be in the order of 75 basis points. Regrettably, the corruption of the data with

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<sup>94</sup> While not intending to provide a complete list of A rated utility issues omitted from the ATCO Pipelines data, S&P rated Canadian Utilities, CU Inc., Hydro One, Maritime Electric, Newfoundland Power and Nova Gas Transmission in the A category at year end. DBRS in addition, as at December 27, 2002, rated certain of the debt instruments of the following issuers within the A rating category: Alliance Pipeline A(low); Aquila Networks Canada (Alberta) A; Caribbean Utilities A(low); Express Pipeline A(low); Maritimes & Northeast Pipeline A; Terasen Pipelines (Trans Mountain) A(low). Issues in the longer range are currently outstanding from Alliance Pipeline and Hydro One among others. While these issuers may have a split rating currently, at some prior period they may have been downgraded by CBRS/S&P and prior thereto would have properly fit within a CBRS/S&P “A” bond rating group.

<sup>95</sup> After reviewing the IR replies in the ATCO Gas application which in content were similar to CAL-AP-76 (d) (g), on November 26, 2002, I examined the list of instruments used by Bloomberg to develop the BBB rated yields and noted that the list included the EPCOR June 2029 and the TransAlta October 2029 issues used in the Foster Associates A rated group.

<sup>96</sup> In CAPP-AP-76, the applicant reports that “There is, however, an approximately 70-75 basis point yield spread between A and BBB rated long-term utility” debt. The reply did not specify the date of the observation, market occurrence of obligation, or the particular term or range of terms considered.

1 BBB issuers in Canada appears to be greater. In the April 14 edition of Credit  
2 Weekly, attached to CAL-AP-76, the spread between an S&P A- issuer and an  
3 S&P BBB issuer in the 10-year term could be even more than 100 basis points. In  
4 the 30-year range the spread could go over 160 basis points.

5 In a limited number of instances, when I compared the yield data to data available  
6 from sources available to me, I found variances which may have been due to the  
7 use of different pricing sources or method of calculation. At September 30, 2000,  
8 the then outstanding bonds in the then sample in CAL-AP-76(d)(g) spreadsheet  
9 have an average life of approximately 27.6 years. By December 2002, the  
10 average life of the selected bonds had fallen only to 25.9 years, as a result of the  
11 passage of time being partly offset by the addition of three new 30-year issues<sup>97</sup>.

12 **Q.21 Do you agree that “current capital market conditions” indicate that “a**  
13 **higher equity risk premium” is warranted?<sup>98</sup>**

14 A If the increase contemplated is sufficiently large so as to take the return to 11.5%,  
15 no, I do not. In the table which earlier presented the NEB formula returns and  
16 resulting equity risk premium, there is a small increase in the equity risk premium  
17 caused by changing interest rates between 1996 and 2003. I am of the opinion  
18 that the NEB adjustment formula results in a rate of return on equity that is well  
19 within the market requirements. In other words, it is generous. The table below  
20 sets out the market to book ratios for TransCanada, and for comparison Canadian  
21 Utilities Limited, calculated based on year end financial statements and the year  
22 end share prices. Other than the 1999 data point for TransCanada, one cannot  
23 help but observe the market to book ratios are well over one. The 1999 data point  
24 for TransCanada was affected by, among other things, \$700 million in write  
25 downs related to its unregulated investments and a cut in the dividend which was  
26 announced on December 8, 1999.

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<sup>97</sup> I was unable to confirm the calculations set out by the applicant in CAL-AP-76 (b), in the early dates this may be due to inclusion in the calculation of average life of bonds not yet issued at that date, including the Enbridge 7.2 % and the Westcoast 7.15% issues.

<sup>98</sup> See page 22 of 63 in the prepared testimony of Kathleen C. McShane, 2003-2004 General Rate Application.

Market to Book	Dec-96	Dec-97	Dec-98	Dec-99	Dec-00	Dec-01	Jun-02	Dec-02
TCPL	1.6 x	2.0 x	1.9 x	1.2 x	1.6 x	1.7 x	2.0 x	1.9x
CU	1.6 x	2.1 x	2.3 x	1.7 x	2.1 x	1.9 x	2.1 x	1.8x <sup>99</sup>
NEB ROE	11.25%	10.67%	10.21%	9.58%	9.90%	9.61%	9.53%	9.53%
ERP	3.30%	3.53%	3.68%	3.89%	3.78%	3.88%	3.90%	3.90%

1 Under the premise that a regulated utility must have the ability to access the  
2 capital markets by offering an appropriate return that will allow it to finance at a  
3 price that represents at least book value, the market to book ratios in the above  
4 table appear to be well in excess of the minimum standard. Some small reduction  
5 in the allowed ROEs would appear to be possible without endangering the  
6 strength of the balance sheets of the utilities governed by the NEB formula.

7 In the RH-4-2001 proceeding, TransCanada made a similar argument<sup>100</sup>  
8 suggesting that the changes in the competitive environment and financial markets  
9 warranted an increase in their ROE. The NEB did not increase their ROE<sup>101</sup>,  
10 apparently rejecting that argument. Fortunately or unfortunately, the market  
11 recognizes the changes to which companies are exposed in the stock price on a  
12 minute-by-minute basis. TransCanada, the public entity which owns the Mainline,  
13 is followed by a host of equity analysts,<sup>102</sup> several bond rating firms and thousands  
14 of investors<sup>103</sup> and potential investors, all of whom to some degree make up the  
15 “market” and affect securities prices with their behavior. The “market” has been  
16 aware of the development of other pipelines for years.<sup>104</sup> The “market” is made

<sup>99</sup> Using the May 16, 2003 closing prices and the March 31, 2003 book values the CU market to book ratio was approximately 1.8 times.

<sup>100</sup> In the Additional Written Evidence of TransCanada PipeLines Limited, November 2001, filed in the RH-4-2001 proceeding, at Page 3 of 9, Answer 3, lines 3 to 5, TransCanada observed that “changes in the competitive environment, combined with developments in financial markets, warrant an increase in the fair return of the Mainline.”

<sup>101</sup> The NEB did allow an increase in the equity layer from 30% to 33%. See page 59 of the RH-4-2001 Decision.

<sup>102</sup> On May 19, 2003, the TransCanada web site showed 9 Canadian based and 3 US based analysts as providing research on TransCanada including, BMO Nesbitt Burns, CIBC World Markets, Edward Jones, FirstEnergy, Goldman Sachs, J. P. Morgan, Merrill Lynch, National Bank Financial, Raymond James, RBC Capital Markets, Scotia Capital and UBS Warburg.

<sup>103</sup> Page 81 of the TransCanada annual report for 2002 shows over 30,000 registered shareholders in each of the last three years. Registered shareholders represent a fraction of the total shareholders since many shareholders will own their shares through accounts registered with an investment dealer.

<sup>104</sup> In the RH-2-94 decision that gave rise to the current adjustment mechanism, the Board observed at page 8, that “TransCanada noted that it can no longer be viewed as a monopoly with respect to deliveries to

1 aware of the economic, competitive and political developments and regulatory  
2 changes through a host of communication options. The “market” is aware of the  
3 return to which the Mainline is entitled under the adjustment mechanism and may  
4 anticipate the result in advance of publication since the formulas are known.<sup>105</sup>

5 The “market” is aware of a cornucopia of alternative investment opportunities in  
6 utilities and other industries in Canada and internationally and, with all this  
7 knowledge, still awards TransCanada a large premium over its book value.

8 Terasen is similarly well followed in the investment community.<sup>106</sup>

9 Canadian Utilities Limited is also followed by a number of equity analysts<sup>107</sup>,  
10 bond rating firms<sup>108</sup> and a host of investors and potential investors. The market  
11 should be well aware of the business of ATCO Pipelines through the Canadian  
12 Utilities Limited public disclosure documents including its Annual Information  
13 Form, Annual and Quarterly reports.

14 **Q.22 Do you agree that the “risk premium analysis should recognize the**  
15 **increasing globalization of capital markets and the increasing proportion of**

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eastern Canadian markets since it faces increased competition from alternative pipelines and supplies, including U.S.-sourced supply. TransCanada pointed out that eastern Canadian local distribution companies (“LDCs”) are diversifying their gas supply portfolios to include, in some cases, up to 30% U.S.-supplied gas and are proposing new pipeline facilities to connect their franchise areas with U.S. supply and storage facilities.”

Among other proposals, applications and decisions throughout the period, on July 3, 1997, Alliance Pipeline Ltd. applied for the necessary certificates and authorizations to construct the Alliance Pipeline which was authorized in decision GH-3-97 issued in November 1998.

<sup>105</sup> The NEB, on December 8, 2000, announced the approved rate of return on common equity of 9.61% for the year 2001, on December 6, 2001 announced the approved rate of return on common equity of 9.53% for the year 2002, and on December 5, 2002 announced the approved rate of return on common equity of 9.79% for the year 2003. Since the formulas are known, and as the inputs become known the results may be estimated and anticipated by market participants. One of the benefits of the implementation of an equity return formula for Alberta based utilities would be the increase in relative certainty in the determination of future rates of return on equity which would arise from that decision.

<sup>106</sup> On May 19, 2003, the Terasen web site showed 9 analysts as providing research on the firm including, BMO Nesbitt Burns, CIBC World Markets, Credit Suisse First Boston, Edward Jones, FirstEnergy, National Bank Financial, Raymond James, RBC Capital Markets and Scotia Capital.

<sup>107</sup> Bloomberg, as of October 1, 2002, showed analyst coverage by BMO Nesbitt Burns, CIBC World Markets, Credit Suisse First Boston, Edward Jones, RBC Capital Markets, Raymond James, Scotia Capital.

<sup>108</sup> Canadian Utilities Limited is rated “A” and CU Inc. is rated “A(high)” by DBRS and S&P rates both companies “A+”. Ratings information is attached to CAL-AP-20 and referred to in the application at line 9 on page 12 of 63 in the prepared testimony of Kathleen C. McShane.

1           **Canadians’ investments in foreign equity securities (particularly U.S.**  
2           **securities)”?<sup>109</sup>**

3           A       It would be impossible to argue that Canadians are not investing  
4           internationally. Whether the proportion of Canadians’ investments in foreign  
5           equity securities is increasing is another of those points of discussion where the  
6           starting point is essential to the outcome. Regretfully, the IFIC data used is not  
7           compelling support for the adoption of U.S. market risk premiums. In CAL-AP-  
8           27 we see that Ms. McShane’s calculation totals only three of the nine broad  
9           classifications used by the Investment Funds Institute to classify the over 1,900  
10          funds that their members manage or sell. Ms. McShane’s calculation ignores that  
11          there are common shares in Balanced and Dividend funds and that foreign or  
12          global funds periodically invest in Canadian stocks.<sup>110</sup> With the ebb and flow of  
13          investments within each of the funds, it is not possible to use the IFIC data by  
14          fund classification to determine the true representation of foreign holdings in  
15          Canadian portfolios. We are also advised that the foreign property limits for  
16          RRSPs have been increased from 20% to 30% since 2000. In fact, the level of  
17          investment in those classes of mutual funds defined as foreign has been in decline  
18          since mid 2000, and the actual level of foreign investment in RRSPs is well below

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<sup>109</sup> 2003-2004 General Rate Application, Section 3, prepared testimony of Kathleen C. McShane page 32 of 63, lines 10 to 12.

<sup>110</sup> See the IFIC data in CAL-AP-27 and CAL-AP-80.

The definition of Balance Fund found on the Investment Fund Institute of Canada web site provides that a balanced fund is “a mutual fund which has an investment policy of “balancing” its portfolio generally by including bonds and shares in varying proportions influenced by the fund’s investment outlook”. By ignoring Canadian and foreign shares in a host of funds, Ms. McShane’s observation of an increase from 29% to 37% in investment in certain types of funds should not be take as proof of a similar increase in the amount of foreign investing. To do so would be to extend beyond what the data will support.

By way of example, the Altamira Balanced Fund as at September 30, 2002, was made up of 61.6% equities of which 17.2% were classified as foreign. As at November 29, 2002, the Mackenzie Cundill Global Balanced Fund Series C had, among other things, 28% equities from Asian countries and 8% Canadian equities. By ignoring the Balanced Fund category, Ms. McShane is ignoring the amount of Canadian and foreign equities in those funds.

The Altamira Dividend fund, which describes itself as investing “mainly in Canadian companies”, was approximately 64% common shares as at September 30, 2002. By ignoring the Dividend Fund category, Ms. McShane is ignoring the amount of Canadian and foreign equities in those funds.

The proportion of foreign investment seems not to be permanent but to be in recent decline. From July 2000 to April 2003, the proportion classified as foreign, as Ms. McShane calculated it, has declined from

1 the limit for most Canadians.<sup>111</sup> The apparent increase in the proportion of foreign  
2 investments in mutual funds and the increases in the authorized foreign  
3 component allowed in RRSPs and other regulated accounts, does not compel us to  
4 adopt the various American investment criteria in Canada. I am of the opinion  
5 that the Canadian market reflects the daily ebb and flow of foreign investment on  
6 a daily basis and has done so since foreign investment began. For that reason, I  
7 would urge that we not be swayed to import foreign investment criteria, since our  
8 market reflects daily the sum of both local and international demand for the  
9 securities offered. This is particularly true for utility stocks, since they are, in the  
10 absence of the scent of a take-over opportunity, the quintessential Canadian  
11 investment. In this regard, it is noteworthy that a tiny percentage of the  
12 registered shareholders of Canadian Utilities Limited are non-Canadian,<sup>112</sup>

13 **Q.23 Can you comment on the risk of loss of the Edmonton gas distribution**  
14 **franchise on ATCO Pipelines<sup>113</sup>?**

15 A. Yes. ATCO Pipelines' franchise loss discussion appears to focus on the  
16 consequential effects on the Pipeline operations of a loss of distribution franchises  
17 and for that reason this allegation of increased risk appears of lesser importance  
18 than the discussion of the competitive matters generally. There appears to be a  
19 mismatch in terms of the expiry of the exclusivity agreement in the north, which  
20 is described as having "only five years to termination", and the expiry of the  
21 current term of the Edmonton franchise in 2005 as part of a series of 10-year  
22 renewals. In tone, this discussion of the implications on capital structure and  
23 return on equity of the potential for one party to the distribution contract to

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43% to 33%. Effectively returning the proportion of "foreign" investments to a level similar to that of April 1999.

<sup>111</sup> See CAL-AP-28, in which we are advised that the average foreign content in RRSPs appears to be 9.9%.

<sup>112</sup> See CAPP-AP-51 in which we are advised that approximately 99.9% of the registered shareholders of Canadian Utilities Limited are Canadian. Mr. McCormick would also agree with the observation of Mr. Lackenbauer, Deputy Chairman of BMO Nesbitt Burns, who in his evidence in the RH-4-2001 proceeding, at page 6, observed "It is noteworthy that few foreign investors are interested in Canadian [u]tility stocks unless there is a strong takeover possibility or a strong growth story. They are not interested in Canadian dividend yield plays and the U.S. utilities provide more attractive opportunities to them."

<sup>113</sup> See page 10 of 63, line 29 to page 11 of 63 line 4 prepared testimony of Kathleen C. McShane.

1 exercise its rights under a provision of the agreement, is much more muted than  
2 the more strident discussion on the same topic that took place in the ATCO Gas  
3 and ATCO Electric applications.<sup>114</sup> In recent decisions, the Board has discouraged  
4 the construction of directly competitive pipeline infrastructure. While the loss of  
5 a distribution franchise may trigger alteration of certain gas transportation  
6 agreements, while the existing gas consumers continue to require energy, and the  
7 Board maintains its policy to avoid duplicative facilities, the ATCO Pipelines  
8 infrastructure will remain in use<sup>115</sup>. For that reason, I concluded that the  
9 allegations of increase risk of loss of distribution franchises did not operate to  
10 materially increase the risks to the pipeline operations.

11 The public disclosure documentation<sup>116</sup> related to the gas distribution franchises  
12 shows them to be long-term arrangements with the option exercise price to be set  
13 by the regulator in the absence of a negotiated agreement. In the one case of a  
14 franchise being lost in the last 30 years, it appears that ATCO Gas received an  
15 amount greater than its book value. Although information requests in the ATCO  
16 Gas application<sup>117</sup> attempted to have that applicant demonstrate what would be the  
17 financial consequence of the sale of some distribution franchise assets, the  
18 applicant did not provide a quantitative reply.

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<sup>114</sup> In those other ATCO applications, the company took the position that the exercise of the option to purchase certain municipal franchises would, for example “challenge the viability of the Company.”

<sup>115</sup> With respect to the Edmonton franchise, ATCO advises in CAL-AP-66, that “Alternative pipeline capacity is currently not available to serve Edmonton’s requirements.” See 2003-2004 ATCO Electric General Rate Application, page 27-7 at lines 24 and 25.

<sup>116</sup> See CAPP-AP-67, CAPP-AP-88 (a) and CAL-AP-20 (c) and (d) which incorporate the ATCO Group annual information form and certain Canadian Utilities and CU Inc. public disclosure documents into the record.

<sup>117</sup> See CAL-AG-16 in the ATCO Gas proceeding.

1 **Q.24 Has Canadian Utilities Limited revised the disclosure in its Annual**  
2 **Information Form to alert investors to the fact that “competitive pressures**  
3 **facing ATCO Pipelines have continued to rise, exposing it to a higher level of**  
4 **business risk than 18 months previously”<sup>118</sup>?**

5 A. Not materially. In reviewing the 2002 CU Inc. Annual Information Form the only  
6 instances where the word competition arises are in respect of the Electrical  
7 Utilities Act, and a discussion of environmental risk. In addition, a review of the  
8 October 22, 2002 Management Discussion and Analysis document finds no  
9 reference to ATCO Pipelines except in the observation that the Board in July  
10 denied a NGTL request to construct certain Fort Saskatchewan facilities, and  
11 notes in respect of both “Regulatory Matters” and “Business Risks” that except  
12 for matters therein disclosed, they “remain substantially unchanged.” Based on  
13 the review of these public disclosure documents, it would appear that the rising  
14 competitive pressures are not yet material, and in fact, the only material matter  
15 was the decision of the Board fully suppressing the NGTL competitive initiative.

16 **Q.25 Where do bond ratings fit within your analysis?**

17 A Bond ratings are one of many sources of information available to the market on an  
18 issuer’s securities. Bond ratings provide the market with an independent  
19 assessment or measure of the relative probability that the debt of the various  
20 issuers will be repaid in accordance with the terms of the instruments. The rating  
21 could be viewed as a proxy for an assessment of business risk and financing risk. I  
22 do not believe that the opinions of bond rating agencies should drive the Canadian  
23 regulatory process.

24 Bond rating does not appear to be an exact science. The ratings for individual  
25 firms are developed through the individual judgment of those employed by the  
26 various rating agencies. Consequently the changing and sometime divergent<sup>119</sup>

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<sup>118</sup> 2003-2004 General Rate Application, Evidence of Kathleen C. McShane, Page 6, lines 21 to 23.

<sup>119</sup> AltaLink has enjoyed an “A (high) rating from DBRS since July 2002, but it appears that S&P was unwilling to grant an “A-“ rating without AltaLink “securing its senior debt by granting a floating charge”. See paragraph 8 to the AltaLink financing approval application dated December 12, 2002.

1 judgments of bond raters, at any particular time, should not be the sole driver of  
2 the allowed return for a regulated utility, and in my view, are no substitute for the  
3 views of the regulator. This is particularly true when the financing entity is also  
4 financing assets beyond those included in the rate base since the financing of  
5 those assets may affect the bond rating upon which the regulated entity will  
6 market its bonds.

7 A company's debt instruments do not always trade in line with the bond rating.  
8 As demand ebbs and flows, spreads will vary from those in the same rating  
9 category. Spreads can widen out before downgrades occur because the debt  
10 markets can respond more quickly to changes in circumstances than do the rating  
11 agencies. Spreads can widen or narrow due to matters not directly related to the  
12 credit quality of the specific company including anticipated financings and  
13 anticipated shortages of new government bonds due to increasing government  
14 surpluses.

15 **Q.26 What is more important an "A" rating or a specific<sup>120</sup> interest coverage ratio?**

16 A Of the two, I would view the "A" rating as more important. However, neither of  
17 those items, the rating or the interest coverage ratio, are as important as the  
18 "market" reaction to the financial position of the company.

19 It is also clear that the various rating benchmarks, including interest coverage  
20 ratios, "are not written in stone". I would observe that TransCanada has been able  
21 to maintain an "A/A-" rating for a number of years without maintaining a 2 times  
22 interest coverage ratio. Other issuers have been awarded an A rating by S&P  
23 without meeting any of their benchmarks<sup>121</sup>. In the sample of six companies with

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<sup>120</sup> In attachment AUMA-AP-11 the lowest pre-tax interest coverage ratio for an "A" rated issuer with an S&P business position rankings of 2, 3 and 4 are respectively 2.3 times, 2.8 times and 3.3 times. See also page 12 of the Prepared Testimony of Kathleen C. McShane, and CAL-AP-21 in which the applicant indicates that the business risk of transmission on the S&P rating scale would be "no less than 4".

<sup>121</sup> Attachment CAL-AP-60 provides the recent compliance with the S&P ratings benchmarks of six Canadian Utility issuers. Three of the six companies in that table, Hydro One, Nova Scotia Power and TransCanada Pipelines, did not meet any of the four S&P rating benchmarks for their business risk ranking. See AUMA-AP-11 for the criteria. The low Canadian interest coverage ratios are also discussed in BR-AP-5 and CAL-AP-24.

1 S&P business position rankings and bond ratings provided in attachment CAL-  
2 AP-60, only one of the six companies met half of the four criteria for its rating  
3 and business position, and three of the six companies met none of the four criteria  
4 for their rating and business position.<sup>122</sup> In respect of the larger sample of 14  
5 utilities considered in Schedule 3, CAL-AP-74 (b) confirms that none have  
6 demonstrated an interest coverage ratio equal to the one recommended for the  
7 applicant. As such, it would appear that slavish adherence to these criteria is  
8 unwarranted.<sup>123</sup>

9 To propose a minimum interest coverage ratio target effectively makes the equity  
10 return a function of the weighted average cost of the existing debt issues and the  
11 current tax rate. The table below provides interest coverage numbers for a  
12 simplified example of a 52.7% debt, 6.0% preferred equity and 41.2% common  
13 equity capital structure using a 36% tax rate for a range of interest and equity  
14 return rates.<sup>124</sup> To maintain a 2.8 times interest coverage ratio as the imbedded  
15 average debt costs increase from 7% to 14%, the after-tax equity return must  
16 increase from approximately 254 basis points greater than the average imbedded  
17 debt rate to 581 basis points greater than the average imbedded debt rate.

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<sup>122</sup> Only one of those six companies, Enbridge Consumers Gas, met two of the S&P rating benchmarks for its business risk ranking. Two of those six companies, Enbridge Inc and Newfoundland Power, met only one of the four S&P rating benchmarks for their business risk ranking. Two of the criteria, FFO/total debt and EBIT interest coverage were not met by any company.

<sup>123</sup> In CAPP-AP-71, the applicant allows that the interest coverage ratios are not absolute targets.

<sup>124</sup> The capital structure numbers are from the 2002 mid year capital ratios found in Table 3.1-1, and the cost rates for the debt and preferred component are the 2003 mid-year cost rate numbers from the same table. The 36% tax rate is the 2003 rate from attachment CAL-AP-81(a) (4.5). There is a similar table solving for the required equity layer to maintain interest coverage ratios between 2.0 and 4.0 times, based on different assumptions as to tax rate and preferred equity layer and cost found in the attachment to BR-AP-5.

Rate Base	\$ 1,000		Pre Tax	Pre Tax
Tax Rate	36%	Rate	Rate	Return
Debt	52.8%	7.56%		\$ 39.88
Preferred	6.0%	5.26%	8.21%	\$ 4.93
Equity	41.2%	8.5%	13.28%	\$ 54.77
				\$ 99.59

Debt Rate	Interest Coverage						
	8.00%	9.00%	10.00%	11.00%	12.00%	13.00%	14.00%
7.0%	2.53	2.70	2.88	3.05	3.23	3.40	3.58
8.0%	2.34	2.49	2.64	2.80	2.95	3.10	3.25
9.0%	2.19	2.33	2.46	2.60	2.73	2.87	3.00
10.0%	2.07	2.19	2.31	2.44	2.56	2.68	2.80
11.0%	1.97	2.08	2.20	2.31	2.42	2.53	2.64
12.0%	1.89	1.99	2.10	2.20	2.30	2.40	2.50
13.0%	1.82	1.92	2.01	2.11	2.20	2.29	2.39
14.0%	1.76	1.85	1.94	2.03	2.11	2.20	2.29

1           One of the principle causes of the current regulatory issue related to the pressure  
2           on interest coverage ratios is the higher embedded cost of debt, which due to its  
3           long term nature is less responsive to change, relative to the current market rates  
4           of return required for equity.

5   **Q.27 Is the 50% Common Equity component of the capital structure appropriate**  
6   **for ATCO Pipelines?**

7   A       The Board has not had to consider the appropriate common equity component for  
8       ATCO Pipelines as a result of the negotiated settlement for APN. In Decision  
9       2001-97, the Board determined that a 45.5% equity layer was appropriate for the  
10       pipeline functions of ATCO Gas South<sup>125</sup>.

11       In addition to the Board’s view of the appropriate level of equity capital contained  
12       in that Decision, we also have some important information of the company’s view  
13       of the appropriate common equity layer contained in the application. In table 3.1-  
14       3, we have the actual capital structure determined by the company to be adequate

<sup>125</sup> See Decision 2001-97 at page 46. In CAL-AP-21, we learn that “Ms. McShane had not considered the two parts [AGN and AGS] separately, nor had she done so in the 2001/2002 GRA. She had no reason to conclude that the business risk profiles of ATCO Pipelines North and South are materially different.”

1 for the ATCO Pipelines North, which contained 38.4% mid-year common equity  
2 in 2001 and 39.8% mid-year common equity in 2002.<sup>126</sup>

3 In the absence of regulation, companies are generally free to choose their capital  
4 structures. While this may be technically true for regulated companies, there is  
5 little incentive for a regulated firm to carry a higher common equity layer than  
6 that allowed in its capital structure, since it will earn a return lower than the  
7 allowed rate on that additional equity.<sup>127</sup> To have an actual capital structure with a  
8 thinner common equity layer than a deemed capital structure does provide an  
9 opportunity to earn an excess return. In the absence of a multi-year negotiated  
10 settlement, there is, though, little incentive to stray too far from the deemed  
11 capital structure since capital structure will be an issue in future rate cases or  
12 negotiations. The North has been under a multi-year negotiated settlement which  
13 has allowed the company to choose its common equity layer. I believe its choice  
14 of a common equity layer in the 38.4% to 39.8% range speaks volumes in  
15 repudiating the current need for to approach a 50% common equity layer. If we  
16 accept the proposition that the business risk profiles of ATCO Pipelines North and  
17 South are not materially different, the 38.4% to 39.8% common equity range  
18 would be appropriate for the company as a whole.<sup>128</sup>

19 As I read the application, ATCO Pipelines addresses competition as its greatest  
20 area of increasing risk in the past 18 months, but while it has expressed this  
21 concern, the recent Board Decision<sup>129</sup> on the Fort Saskatchewan facilities  
22 application seems to continue the policy of only permitting development of  
23 additional infrastructure on the basis of clear need and efficient operation. At  
24 worst, the record shows that there are still a number of issues to be resolved<sup>130</sup>, but  
25 as time and business do not stand still, the development of new issues to be

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<sup>126</sup> See CAPP-AP-11 for the correction for 2001. See also AUMA-AP-5.

<sup>127</sup> I believe these factors explain Ms. McShane's observation that there is a broader range of capital structure ratios in unregulated industries. See CAP-AP-7(a).

<sup>128</sup> See CAL-AP-21(b).

<sup>129</sup> See the discussion of Board Decision 2002-058 at page 10 of 63, Prepared Testimony of Kathleen C. McShane.

<sup>130</sup> See page 11 of 63, lines 28-29, Prepared Testimony of Kathleen C. McShane.

1 resolved is essentially a continuing process. Within the general heading of the  
2 competitive landscape, another change in risk identified by the applicant is the  
3 possibility of the sale of the Edmonton franchises by one of its affiliates under an  
4 option contained in the franchise agreement. While the option in the franchise  
5 agreement has existed for years, it cannot be exercised until late 2005, outside the  
6 period considered in this application.

7 Ignoring the ever-present worry that some investors may form conclusions not  
8 supported by facts, the other major justification for the proposed increase in  
9 equity layer appears to be the “requirement” for the applicant to do its share to  
10 maintain the current debt rating of its parents. The Standard and Poor’s rating  
11 outlook was revised for “ATCO Ltd. and subsidiaries Canadian Utilities Ltd and  
12 CU Inc. to negative”<sup>131</sup> on November 12, 2002. In that announcement, S&P  
13 focused on the increase in “ATCO’s business risk” including “growing  
14 investments in nonregulated independent power ... growing merchant power  
15 exposure ... and the growth of nonutility operations.” S&P also noted “The  
16 consolidated business risk profile of ATCO is supported by Alberta-based  
17 regulated gas and electricity distribution and transmission operations, ...  
18 Distribution businesses have virtually no exposure to market price and volume  
19 risk, as they are permitted to flow through all electricity and natural gas supply  
20 costs.” While S&P has commented on what it perceives to be the relatively thin  
21 equity layer allowed regulated Canadian utilities, the specific statements in the  
22 November 12, 2002 S&P comment seem to me to demonstrate that the increasing  
23 business risk is due to the “growth of nonutility operations”. As such, it appears  
24 that ATCO Pipelines is doing its share.

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<sup>131</sup> While the June 26, 2001 S&P rating (with a stable outlook) for ATCO and related entities, and the March 5, 2003, S&P announcement related to S&P’s reassessment of regulation as a ratings factor, are included in attachment CAL-AP-20(a), the November 12, 2002 announcement (revising the outlook to negative) was not incorporated in that reply, but its existence and the cited concerns are confirmed in CAL-AP-69 (h). The November 12, 2002 announcement was filed as part of BR-ATCOGTA-51 in the recent ATCO Electric proceeding. See attachment AUMA-AP-11 for the S&P financial targets of debt to total capital for various business position categorizations.

1 **Q.28 Will an adjustment mechanism work well in any circumstance?**

2 A Any system created by human beings suffers from limitations, and as such, there  
3 may develop in the future a confluence of events in which the current adjustment  
4 mechanisms used by the NEB and the BCUC would not provide an adequate  
5 return for a regulated company. However, it seems clear to me that these  
6 adjustment mechanisms have performed well for a number of years. TransCanada  
7 has been able to access the capital markets on a reasonable basis. The high market  
8 to book ratio currently enjoyed by TransCanada and Terasen (formerly BC Gas)  
9 shareholders provide tangible support for the view that these formulas continue to  
10 work well.

11 **Conclusion**

12 **Q.29 Please review your conclusions.**

13 A. The combination of the 11.5% equity return applied for and the 50% common  
14 equity ratio appear to be in excess of the current requirements of the financial  
15 markets, relative to the markets' perception of the underlying business risk of  
16 ATCO Pipelines.

17 A more appropriate equity return would be one derived from a formula similar to  
18 those used by the NEB or the BCUC, adjusted to recognize the shares of  
19 companies which are the owners of most regulated utilities subject to those  
20 formulas are trading at substantial premiums to the underlying book values. That  
21 adjustment should reduce the return on equity to the 8.5% level recommended by  
22 Drs. Booth and Berkowitz.

23 The proposed capital structure places an unnecessary burden on the ratepayer as  
24 the equity layer increases beyond that which was approved by this Board in  
25 Decision 2001-97 for ATCO Pipelines South, and the levels at which the  
26 consolidated ATCO Pipelines has chosen to operate in recent years.

27 **Q.30 Before concluding, have you ever given evidence in a regulatory proceeding?**

28 A. Yes. I have appeared in five regulatory proceedings.

1 In 2001, I was retained by the Alberta Energy and Utilities Board as an  
2 independent financial expert to give evidence at the 2000 Pool Price Deferral  
3 Accounts Proceeding.<sup>132</sup> The 2000 Pool Price Deferral Accounts Proceeding was  
4 convened to permit the AEUB to determine the amount payable to the owners of  
5 six electrical distribution systems in respect of the prudent cost of financing of the  
6 deferral accounts, which in aggregate were approximately \$632 million. Pursuant  
7 to the relevant regulation, the prudent cost of financing of the deferral accounts  
8 could include the costs of “debt financing, equity financing or a combination of  
9 debt and equity financing.”<sup>133</sup> My duties included, among other things, analysis of  
10 the applications, and; filing a written submission on the prudent financing options,  
11 cost of financing, impact of debt financing on capital structure and the impact of  
12 the cost of financing for other corporate purposes.<sup>134</sup>

13 In 2002, I filed evidence and appeared as a financial expert, having been retained  
14 by the Canadian Association of Petroleum Producers (“CAPP”) to give evidence  
15 in respect of the TransCanada Pipelines 2001 and 2002 Fair Return Application  
16 heard before the NEB in proceeding RH-4-2001<sup>135</sup>. The 2001 and 2002 Fair  
17 Return Application Proceeding was convened to consider, among other things,  
18 whether TransCanada’s “currently-approved return, based on a deemed capital  
19 structure of 30% common equity and the rate of return on common equity (ROE)  
20 resulting from the RH-2-94 Formula”<sup>136</sup> was appropriate. My duties included,  
21 among other things, analysis of the application, reviewing financial market data  
22 with respect to TransCanada and certain companies and; filing a written  
23 submission in which I concluded that the ROE adjustment mechanism had

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<sup>132</sup> See the various decisions related to the proceedings including Alberta Energy and Utilities Board Decision 2001-92. In addition to written evidence, Mr. McCormick was examined on July 27, 28, and 30, 2001.

<sup>133</sup> See section 4 of the Deferral Accounts Deficiency Correction Regulation, Alberta Regulation 240/2000. Decision 2001-93.

<sup>135</sup> In addition to filing written evidence, Mr. McCormick was examined on March 19, 2002.

<sup>136</sup> RH-4-2001 Decision, page 1. In its decision, the NEB increased the Mainline’s deemed common equity ratio to 33% from 30% and determined that the rate of return on common equity resulting from the RH-2-94 Decision should continue to apply. See pages 59 and 56. TransCanada filed an application for Review and Variance in respect of this decision dated September 16, 2002, and following its denial, is now under appeal to the Federal Court of Appeal..

1 performed well, allowing TransCanada to access the capital markets on a  
2 reasonable basis.

3 In addition, I have recently appeared in three recent applications before the  
4 Alberta Energy and Utilities Board including, the AltaLink application number  
5 1279345, the ATCO Gas application number 1275466, and, the ATCO Electric  
6 application number 1275494.

7 **Q.31 Does this conclude your evidence?**

8 A Yes.

**ATTACHMENT 1**

## PROFESSIONAL QUALIFICATIONS OF JOHN D. McCORMICK

### *Academic Training*

LL.B. from the University of Alberta (1978)  
M.B.A. in Accounting from the University of Alberta (1975)  
B.A. in Political Science, from the University of Calgary (1972)

### *Professional Organizations*

Law Society of Alberta

### *Professional Experience*

September 1975 - May 1978 - Sessional Lecturer for the Department of Accounting, the Faculty of Business Administration and Commerce, the University of Alberta

June 1978 - March 1983 – Barrister & Solicitor and Articling Student, Parlee, Irving, Henning, Mustard & Rodney, Edmonton

September 1980 - May 1982 - Sessional Lecturer (M.B.A. Tax) for the Department of Legal and Industrial Relations, the Faculty of Business Administration and Commerce, the University of Alberta

March 1983 - October 1991 – Associate rising to Vice-President and Director, ScotiaMcLeod, Toronto and Calgary

In this capacity, Mr. McCormick represented the firm in transactions ranging from small private placements to major financings including the initial public offerings of Telus and Petro-Canada. The transactions included the issuance of preferred and common shares, special warrants, rights, warrants, partnership units, and trust and royalty units . . . domestic deals and crossborder financings. He executed approximately \$5 billion of financing, wrote five trust deeds for major borrowers in the energy industry covering secured and unsecured obligations in the domestic and European markets, and assisted a major airline to renegotiate the terms of its convertible debentures with key financial institutions. In the utility area, he provided coverage of a number of western Canadian utility issuers including Nova, Alberta Natural Gas and Foothills Pipe Lines. He developed expertise in a number of industries including Canadian energy and petroleum services, pipelines, basic and specialty chemicals, airlines, pulp and forest products, telephone and telecommunications, and magnesium.

November 1991 – January 1994 – President, J. D. McCormick Financial Services, Inc., Calgary

January 1994 – January 1997 – Vice-President & Director, Levesque Beaubien Geoffrion, Calgary

In this capacity, Mr. McCormick was responsible for account coverage of over 125 account relationships in Alberta, British Columbia and Saskatchewan. He gained additional expertise in the banking, gold and satellite communications industries.

January 1997 – October 1997 – President, J. D. McCormick Financial Services, Inc., Calgary

October 1997 - May 1998 – Sprott Securities, Calgary

May 1998 – present – President, J. D. McCormick Financial Services, Inc., Calgary

In this capacity, Mr. McCormick secured and executed valuation and financial advice assignments with junior and senior public companies and government. He assisted a senior issuer in a securitization transaction. He provided financial advice with respect to the recapitalization of Sunoma and Barrington, which had over \$400 million in debt, fairness opinions to directors of TSE, CDNX and ASE listed companies. He provided financial advice in respect of several oil and gas industry merger and acquisition assignments, including advice to Tappit in respect of its attempted \$13 million hostile takeover of Backer, and expert testimony or reports in three securities cases in Alberta and Saskatchewan. Among other things, he was retained to provide, strategic advice with respect to several corporate reorganizations, a valuation of a U.S. corporation with equity valued at over \$200 million and strategic advice to its owner, advice in respect of a \$15 million equity financing, the negotiation of a long term joint venture, disposition of an oil services firm, and, advice in respect of software company concerning a private placement by a major industry partner.

#### *Previous Expert Reports*

Mr. McCormick was retained by the Alberta Energy and Utilities Board to give evidence at the 2000 Pool Price Deferral Accounts Proceeding, which resulted in Decision 2001-92, and by the Canadian Association of Petroleum Producers to give evidence at the TransCanada Pipelines 2001 and 2002 Fair Return Application proceeding, which resulted in Decision RH-4-2001. Mr. McCormick was retained by the City of Calgary to give evidence before the Alberta Energy and Utilities Board in respect of the recent AltaLink application, number 1279345, ATCO Gas application number 1275466 and the ATCO Electric application number 1275494, for which decisions are pending.. He has provided expert reports in respect of a number of lawsuits related to securities matters.